Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matters of	)	
	)	
Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit	)	
	)	
Bell Atlantic (North) Telephone Companies' Continuing Property Records Audit	)	
	)	
Bell Atlantic (South) Telephone Companies' Continuing Property Records Audit	)	CC Docket No. 99-117
	)	
BellSouth Telecommunications Continuing Property Records Audit	)	ASD File No. 99-22
	)	
Pacific Bell and Nevada Bell Telephone Companies' Continuing Property Records Audit	)	
	)	
Southwestern Bell Telephone Company's Continuing Property Records Audit	)	
	)	
US West Telephone Companies' Continuing Property Records Audit	)	

REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.

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SUMMARY

In this Reply U S WEST responds to the comments of AT&T and MCI on the Accounting Safeguard Division's ("ASD") audit of U S WEST's continuing property records ("CPR") audit for hardwired central office equipment ("COE"). Not surprisingly, AT&T and MCI, the RBOCs' largest customers, conclude that price cap rates must be reduced as a result of the audit findings. To support this position, AT&T and MCI imply that there has been a vast and longstanding conspiracy among the RBOCs to defraud the public by overstating their COE investment through the inclusion of "phantom" plant. These arguments find no support in the audit report and only demonstrate the extremes to which these interexchange carriers ("IXC") will go to reduce access charge costs if there is no downside risk to them. The Commission should reject these arguments as frivolous.

Even AT&T's and MCI's unequivocal support of the ASD's audit procedures and findings cannot rehabilitate the CPR audit -- it is fatally flawed. There is not just "one weak link;" there are many. The ASD's audit results cannot be saved by fixing a few minor errors. The audit is flawed from the selection of the initial U S WEST sample to the ASD's extrapolation to the entire universe of COE hardwired investment. As such, it is impossible to draw any valid conclusions from the ASD's audit with respect to the status of U S WEST's hardwired COE investment. Furthermore, the CPR audit, as AT&T's own expert acknowledges, was a special purpose audit of limited scope that never included "completeness" as an objective. Thus, even if the audit was not flawed from a statistical prospective, it

still would not be possible to draw any valid conclusions with respect to the appropriateness of U S WEST's COE account balances.

In this Reply, U S WEST offers extensive comment on the shortcomings in the ASD's statistical methodology and audit procedures. Unfortunately, these comments will probably be ignored by the ASD once again -- but the Commission should not ignore them. The problem is that the ASD persists in trying to portray the CPR audit -- which is a special purpose audit of limited scope -- into something that it cannot be -- an audit which complies with Generally Accepted Auditing Standards ("GAAS"). The audit was designed to focus on compliance with the Commission's CPR recordkeeping requirements and the Commission should limit its inquiry accordingly.

U S WEST acknowledges that its continuing property records are not error-free. It also acknowledges that its internal processes for maintaining continuing property records could be improved and that it is taking steps to correct any deficiencies in its processes. U S WEST is willing to work with the Commission to address concerns that the Commission might have with respect to U S WEST's records. However, U S WEST would be remiss if it, once again, did not express both its concern and dissatisfaction with the ASD's audit report. It neither recognizes the extraordinarily detailed and burdensome nature of the Commission's continuing property recordkeeping rules, nor U S WEST's efforts to comply with these rules and correct inaccuracies in the ASD's field audit.

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REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.

U S WEST Communications, Inc. ("U S WEST"), through counsel and pursuant to the Federal Communications Commission's ("Commission") Notice of Inquiry ("Notice")[1] hereby replies to comments filed by other parties in the above-

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[1] In the Matters of: Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit; Bell Atlantic (North) Telephone Companies' Continuing Property Records Audit; Bell Atlantic (South) Telephone Companies' Continuing Property Records Audit; BellSouth Telecommunications' Continuing Property Records Audit; Pacific Bell and Nevada Bell Telephone Companies' Continuing Property Records Audit; Southwestern Bell Telephone Company's

captioned proceeding on the Continuing Property Records ("CPR") audits of the Regional Bell Operating Company's ("RBOC") performed by the Accounting Safeguards Division ("ASD") of the Common Carrier Bureau.[2]

I. INTRODUCTION

Comments were filed by three types of parties: local exchange carriers ("LEC") (i.e., the above-captioned RBOCs, GTE, and USTA), state regulatory commissions and officials (i.e., Illinois Commerce Commission, Florida Public Service Commission, and the New York Attorney General), and interexchange carriers ("IXC") (i.e., AT&T Corp. ("AT&T") and MCI WorldCom, Inc. ("MCI")).

The LECs were uniformly critical of the ASD's statistical methodology, audit procedures, audit findings, and recommendations. The states comments were mixed and focused on the LECs serving their respective states (i.e., Ameritech, Bell

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Continuing Property Records Audit; US West Telephone Companies' Continuing Property Records Audit, Notice of Inquiry, 14 FCC Rcd. 7019 (1999) ("Notice"). And see Order, CC Docket No. 99-117 and ASD File No. 99-22, DA 99-1855, rel. Sep. 10, 1999.

[2] **U S WEST plans to amend these comments in the near future to reflect revisions to the ASD's December 22, 1998 audit report which were released on Friday afternoon, October 22, 1999.** See Public Notice, DA 99-2282, Corrections to Audit Reports of the Bell Operating Companies' Continuing Property Records CC Docket No. 99-117, ASD File No. 22, rel. Oct. 22, 1999. Due to the lateness in receiving the audit report revisions, neither U S WEST nor its experts, Mr. Carl Geppert of Arthur Andersen and Ms. Ann Thornton of Deloitte & Touche, have had sufficient time to review and evaluate the ASD's changes prior to today's filing deadline. In order to comply with the Commission's due date for reply comments, U S WEST is filing this reply without reference to the ASD's revisions. Needless to say, any "correction" that increases the ASD's estimate of "missing" hardwired COE investment for U S WEST by more than $125 million dollars cannot be described as a small error and deserves close scrutiny. If anything, these revisions should raise even more questions as to the reasonableness and validity of the ASD's audit process.

Atlantic and Bell South).[3] Conversely, AT&T and MCI found no fault with the ASD's audit procedures or findings and urged the Commission to initiate enforcement action against the RBOCs.

Not surprisingly, AT&T and MCI, the RBOCs' largest customers, concluded that price cap rates must be reduced as a result of the audit findings. To support this position, AT&T and MCI imply that there has been a vast and longstanding conspiracy among the RBOCs to defraud the public by overstating their central office equipment ("COE") investment through the inclusion of "phantom" plant. The Commission should reject these arguments as nonsense! The audit reports provide no basis for the IXCs' theory. The IXCs' arguments only demonstrate the extremes to which they will go to reduce their access charge costs if there is no downside risk to them.[4]

[3] As such, U S WEST will not reply to the States' comments.

[4] It is particularly ironic that AT&T is an advocate of such a position given the fact that the current detailed continuing property record ("DCPR") system is largely the product of AT&T's handiwork in the decades before divestiture. If AT&T and MCI were subject to the same onerous CPR requirements and scrutiny as the RBOCs, it is doubtful that they would be making these same arguments.

It should also be noted that U S WEST has never claimed that its DCPRs are error-free. U S WEST admits that errors will arise in a system covering more than 500,000 CPRs. No system of internal controls is error-free. The cost of establishing systems to detect errors, in particular accounting systems, must always be considered in light of the associated benefits. Regardless of this, U S WEST does not believe that the ASD's audit report is an accurate representation of its error level and has presented evidence to the contrary.

In the comments which follow, U S WEST will focus on the ASD's audit of U S WEST's CPRs and AT&T's and MCI's comments.[5]

II. AT&T's AND MCI's COMMENTS SUFFER BOTH FROM ERRORS OF COMMISSION AND OMISSION

A. What They Said

AT&T's and MCI's comments are very similar both in terms of their positions and inflammatory rhetoric. They unequivocally support the ASD's reported audit findings in hopes of translating them into another access charge rate reduction. Their comments can be summarized a follows:

- The statistical techniques used by ASD's auditors were valid and proper.[6]
  - -- RBOC criticisms of the ASD's two-stage stratification are unfounded.[7]
  - -- The ASD auditors had no valid reason to conduct a two-way audit.[8]
  - -- The best estimate of the amount of overstatement of COE hardwired investment is the point estimate[9] and the selection of a 95% confidence interval was reasonable.[10]
  - -- The exclusion of small offices from the sample selection was reasonable and favored the RBOCs.[11]

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[5] While many of AT&T's and MCI's comments generically refer to the RBOCs, U S WEST assumes that they also apply equally to the U S WEST audit since the ASD purportedly employed the same statistical techniques and audit procedures.

[6] MCI at 3, 23; AT&T at 6-13.

[7] AT&T at Robert M. Bell Affidavit at 3-6 ("Robert Bell Affidavit").

[8] MCI at 8; AT&T at 10-12.

[9] AT&T at 25; MCI at 23; Robert Bell Affidavit at 13-15.

[10] MCI at 25; AT&T at 24-26.

- The ASD's scoring and rescoring procedures were reasonable and overly generous to the RBOCs.[12]

- The ASD's audit procedures complied with GAAS and GAGAS.[13]

- The existence of undetailed investment after the implementation of PICS/DCPR violates the Part 32 property record rules and all undetailed investment must be classified as missing.[14]

- RBOC revenue requirements are overstated due to "phantom" plant investment and excess depreciation expense and price cap rates should be adjusted.[15]

  -- The Commission must assume that missing RBOC equipment was never placed in service and never existed.[16]

  -- Delayed and omitted retirements inflate depreciation expense.[17]

  -- Initial price cap rates were overstated due to the overstatement of RBOC hardwired COE investment during 1990-91[18] and the Commission should order a prospective downward adjustment.[19]

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[11] AT&T at 10; Robert Bell Affidavit at 6-7.

[12] AT&T at 13-20; MCI at 12, 14; AT&T at James K. Loebbecke Affidavit at 6 ("Loebbecke Affidavit").

[13] AT&T at 21-23; Loebbecke Affidavit at 9-10.

[14] AT&T at 36-38; MCI at 26-34.

[15] MCI at 34-41; AT&T at 35-36.

[16] MCI at 35; MCI at Report on the Impact of Missing Plant on ILEC Revenue Requirements, Prepared by Snavely King Majoros O'Connor & Lee, Inc. ("Lee Report"); AT&T at 38-39.

[17] MCI at 36; Lee Report at 6-11; AT&T at 29-35.

[18] MCI at 38-40; AT&T at 31-33.

[19] AT&T excepts from this recommendation all LEC signatories to the CALLS proposal on the grounds that it "has agreed that the price cap changes proposed in the plan are 'just, reasonable and fair' -- and prospective changes in interstate access rates . . . based on results of the Continuing Property Records audits shall be 'unnecessary' . . . ." (AT&T at 33 n.28). These statements highlight the fact that AT&T views the CPR audits as just another opportunity to argue that LEC access

Needless to say, AT&T and MCI's comments lead to the inescapable conclusion that RBOC price cap rates must be reduced. This view neither finds support in the audit reports nor logic. It is based on the unsubstantiated claim that "phantom" plant exists on the books of RBOCs and totally ignores the detailed responses of U S WEST and other RBOCs to the ASD's audit reports.

B. <u>What They Didn't Say</u>

AT&T and MCI have had more than five months to review U S WEST's audit reports and response.[20] U S WEST's response raised significant issues with respect to the validity and reasonableness of both the ASD's statistical methodology and audit procedures. To date, neither AT&T and MCI nor the ASD has addressed these criticisms/observations with any degree of adequacy. In many cases, U S WEST's observations and criticisms of the ASD's draft audit report were simply ignored. This is inexcusable given the severity of the ASD recommendations and AT&T's and MCI's proposed remedies.

With respect to the merits of the ASD's statistical techniques, AT&T and MCI:

- Totally ignore the size of the precision range in relation to the size of the estimate. In the case of U S WEST, the total range of uncertainty

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charges should be reduced to even lower levels than dictated by price cap regulation.

[20] The audit reports and responses were released on March 12, 1999. <u>See</u> <u>In the Matter of US West Telephone Operating Companies' Continuing Property Records Audit</u>, ASD File No. 99-22, <u>Order</u>, FCC 99-30 rel. Mar. 12, 1999.

is $394.8 million which is larger than the ASD's estimate of $378.6 million.[21]

- Make no reference to the fact other government agencies employ sampling guidelines for precision (e.g., one IRS regulation indicates that the precision of an estimate should not exceed 10% of the estimate at a 95% confidence level).[22]

- Say nothing about the large number of strata and small number of selections per strata.[23]

- Summarily dismiss comments on the significance of understatement errors (that would be detected through the use of a two-way audit).[24]

- Totally ignore U S WEST's comments that there is no statistical support for the assertion that "the actual cost of missing plant lies closer to the mid-point of the range."[25]

- Gloss over the fact that "any individual sampling estimate within a precision range should be considered to be equally likely of being the actual amount of the error."[26]

- Gloss over the fact that in sampling from accounting populations dollar-based selection techniques are usually employed rather than simple random selection to allow for appropriate coverage of higher value items.[27]

With regard to U S WEST's comments on audit procedures and other matters, AT&T and MCI:

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[21] See Attachment 1, Letter from Ann Thornton, Deloitte & Touche to Mr. Mark A. Schumacher, U S WEST, dated Jan. 8, 1999.

[22] Id.

[23] Id.

[24] Id.

[25] Id.

[26] Id.

[27] Id.

- Totally ignore the fact that the ASD's rescoring methodology and "probative evidence" standard was not made available to RBOCs until long after the audit and RBOC data submissions.[28]

- Make no mention of the fact that the ASD's "probative evidence" standard is a far stricter standard than is normally used in audits.[29]

- Totally ignore U S WEST's explanation of its use of "Undetailed Investment" as a clearing category and the amounts in it.[30]

AT&T and MCI's comments -- no matter how laudatory -- cannot save the ASD's audit. As U S WEST demonstrated in its comments and in the sections which follow, the ASD's audit is "irretrievably broken" and AT&T and MCI's unsubstantiated claims and disregard of valid RBOC criticisms cannot fix it.

ARGUMENT

I. AT&T's AND MCI's ASSERTION THAT RBOC PRICE CAP RATES ARE OVERSTATED AS A RESULT CPR ERRORS IS MERITLESS

In its comments, U S WEST urged the Commission to avoid unnecessary and acrimonious debate by taking "official notice" of the fact that the CPR audit results cannot have an impact on customer rates under remaining life depreciation and price cap regulation.[31] U S WEST reiterates its request in this reply.

To support this obvious conclusion, U S WEST referenced Dr. Taylor's Affidavit submitted in the USTA's filing.[32] In his Affidavit, Dr. Taylor observes that

[28] U S WEST Comments filed Sep. 23, 1999 at 16.

[29] Id. and see id. at Attachment 2, Geppert Sep. 23, 1999 Declaration at 11.

[30] See U S WEST January 11, 1999 Response at 22-24.

[31] U S WEST Comments at 3.

[32] Id. at 25-27.

the only possible way that rates might be affected is indirectly through the impact of delayed retirements on the lower formula adjustment ("LFAM") or the sharing mechanism.[33] Dr. Taylor demonstrates that "[R]etiring an asset after discovering that it is missing does not change the rate base in the [Uniform System of Accounts] USOA and has very little effect on depreciation expenses."[34] Consequently, Dr. Taylor finds that delayed retirements have no impact on LFAM or sharing and that "ratepayers have not paid more (or less) for the services they have received because a small number of asset retirements were allegedly not reflected accurately in the CPR."[35]

Regardless of their familiarity with the price cap mechanism, AT&T and MCI still argue that price cap rates must be reduced on a prospective basis.[36] They proffer three reasons to support their contention that price cap rates are overstated. First and foremost is their claim that missing RBOC hardwired COE was never placed in service (i.e., "phantom plant").[37] Next, they assert that delayed and omitted retirements inflate depreciation expense under remaining life depreciation.[38] And, third they assert that hardwired COE investment that was found to be missing during the 1997 CPR audit must also have been missing in

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[33] Comments of the United States Telephone Association, filed herein, Sep. 13, 1999 at Affidavit of William E. Taylor at 10-14 ("Taylor Affidavit").

[34] Id. at 3-4.

[35] Id.

[36] AT&T at 36-37; MCI at 31-34.

[37] AT&T at 29-30; MCI at 35.

[38] MCI at 36; AT&T at 28-36.

1990 when price cap regulation was initiated.[39] None of these assertions "hold water," as U S WEST demonstrates below.

C. Phantom Plant

In claiming that U S WEST's revenue requirements and rates are overstated due to the existence of "phantom plant," AT&T and MCI in fact are alleging that U S WEST has engaged in fraud by recording "nonexistent" hardwired COE equipment on its books. There is no truth to this unsupported allegation.

Ignoring all but the ASD's overly-restrictive and arbitrary "probative evidence" standard, AT&T and MCI boldly assert that the RBOCs haven't proved that "missing" COE equipment ever existed in the first place. Therefore, RBOC books should be adjusted to reflect removal of such phantom plant. The Commission should reject AT&T and MCI's self-serving arguments. As Mr. Geppert points out:

> This contention [that plant was never placed in service] was never raised in the ASD's Audit Report for good reason - the ASD audit was neither designed nor performed with the intent to draw such conclusions. As noted above, the type of audit performed by the ASD does not support an opinion of any kind with respect to the fairness of COE plant account balances.[40]

Thus, the ASD's audit provides no support -- nor can it -- for the IXC's "phantom plant" arguments.

In order to eliminate any lingering concerns which may remain about the possible existence of "phantom plant on its books, U S WEST asked Mr. Geppert,

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[39] AT&T at 31; MCI at 33-34.

the Audit Engagement Partner for U S WEST's external auditor, Arthur Andersen, to address the issue. Mr. Geppert states:

> An even more troubling implication of these "phantom plant" contentions is that the Company has intentionally misstated its financial records by recording assets in the financial statements that never existed - in other words, significant fraudulent financial reporting has occurred. Clearly this is not the case. GAAS require the independent auditor, on an annual basis, "to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."[41] AA [Arthur Andersen] has performed the audits of U S WEST's consolidated financial statements beginning in 1996. Prior to 1996, the annual audits were performed by another "Big 5" public accounting firm. Our audit work from 1996 to the present date, as well as our communications with the predecessor auditors and review of their audit workpapers, has uncovered no instances of material misstatement of the financial statements due to fraud.[42]

D. Depreciation Expense

MCI asserts that RBOC depreciation expenses have been inflated as a result of two effects: 1) the effect of depreciating plant that was never placed in service (i.e., phantom plant);[43] and 2) the effect of delayed retirements.[44] Neither MCI nor its consultant, Mr. Lee of Snavely King, provide any evidence to substantiate their claim of the existence of "phantom plant," nor can they on the basis of the ASD' audit reports (as noted in Mr. Geppert's comments in the preceding section).[45]

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[40] Attachment 2, Reply Declaration of Carl R. Geppert at 12-13 ("Geppert Oct. 25, 1999 Declaration").

[41] AICPA, Statements on Auditing Standards, AU Section 316: Consideration of Fraud in a Financial Statement Audit, "Introduction."

[42] Attachment 2, Geppert Oct. 25, 1999 Declaration at 13.

[43] MCI at 35, Lee Report at 4-6.

[44] MCI at 36, Lee Report at 6-9.

[45] Attachment 2, Geppert Oct. 25, 1999 Declaration at 13.

Regardless of the design of the ASD's CPR audit, as noted above, no evidence has been discovered that "phantom plant" exists on U S WEST's books. Thus, if anything is nonexistent (i.e., "phantom"), it is the first factor that MCI proposes to substantiate its claim of inflated depreciation expense.

Even though Mr. Lee agrees that the RBOC rate bases have not been overstated due to delayed retirements, he still claims that depreciation expense has been overstated.[46] He bases this conclusion on the claim that the remaining life would increase as a result of delayed retirements. This would in turn lead to an increase in depreciation expense. To demonstrate this, Mr. Lee provides an oversimplified example which is based on erroneous assumptions. Both Mr. Lee's "theory" and his example are wrong.

Mr. Lee's example is based on the following incorrect assumptions:[47]

- A large percentage, 20%**,** of the investment had not been retired timely;
- All retirements should have been made from the oldest vintages.

In actuality, the following is true for U S WEST.

- The CPR audit indicates that a very small percentage of hardwired COE investment was not retired in a timely manner (i.e., $1.4 million).
- Over 60% of the $1.4 million audit exceptions were in the vintages of 1992 through 1997.

[46] Lee Report at 6.

[47] Id. at 11.

When Mr. Lee's simple example is modified to spread 60% of the delayed/omitted retirements over the most recent vintages, the remaining life would go down (as shown in Attachment 3), not up as Mr. Lee contends. Also, using Mr. Lee's example but dispersing the retirements throughout the vintages shows there would be no change either in remaining life or depreciation expense. Thus, when Mr. Lee's assumptions are modified to reflect reality, his example not only fails to support his position but appears to support the views of William E. Taylor (USTA) and White, RBOC depreciation experts.

As Dr. Ronald E. White, Bell Atlantic's depreciation expert, explains: "The timing of depreciation expense and the size of the depreciation reserve will be changed by omitted retirements to the extent that the remaining life used in the calculation of depreciation expense is changed."[48] And, as noted by both Dr. White and Dr. Taylor, when unbooked retirements are small and dispersed throughout the vintages, there would be no, to possibly a miniscule and incalculable, impact on the remaining life calculation and thus on depreciation expense.[49] Dr Taylor concludes that "the direction of these effects on depreciation expense cannot be calculated and the magnitude of the effects is small because the assets to be retired are a small fraction of the plant in service."[50] In concluding, Dr. Taylor states: "even if the audit were correct, the delayed retirements would have no effect on current revenue

[48] Bell Atlantic Jan. 11, 1999 Letter to Robert E. Hood, Federal Communications Commission, re: FCC CPD Audit -- Response to Audit Staff Reports at Exhibit 5, Affidavit of Ronald E. White, PH.D., dated Aug. 17, 1998 at 3 ("White Affidavit").

[49] White Affidavit at 5-6, Taylor Affidavit at 9.

[50] Taylor Affidavit at 9.

requirements, and the requirements that did not take place in previous periods would have no effect on revenue requirements in those periods."[51]

E. Initial Price Cap Rates

AT&T and MCI assert that the CPR audit results require that RBOC price cap rates be subject to a prospective downward adjustment. According to these IXCs, this is necessary because "substantial excessive costs are almost certainly embedded in the LECs' price cap indices."[52] AT&T supports this position with statements like the following: "If anything, the audit reports and RBOCs' responses indicate that the RBOCs' CPR problems were much worse in the early 1990s than today."[53] The Commission should reject the IXCs' position. It is impossible to attribute 1997 audit results, even if true, to a point more than seven years earlier in time. As U S WEST stated in its opening comments:

> [I]t is impossible to draw any conclusions with respect to "missing" COE plant in 1990 at the inception of price cap regulation -- more than seven years before the CPR audit was performed.[54]

Mr. Geppert also takes issue with the IXCs' position. He states that "an analysis of authoritative auditing standards indicates that such an attribution cannot be made" for the following reasons:[55]

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[51] Id.

[52] AT&T at 33; also see MCI at 38-40.

[53] AT&T at 32. Such unsupported statements would appear to be more suitable in a "supermarket tabloid" than in comments in this NOI proceeding.

[54] U S WEST Comments at 28.

[55] Attachment 2, Geppert Oct. 25, 1999 Declaration at 11-12.

- The ASD did not review internal controls over the hardwired COE accounts throughout the period from 1991 to 1997. Thus, no assumptions can be made with respect to the controls designed and in place throughout that period. Clearly one cannot assume that asset overstatements, to the extent that they exist, were equal to, higher or lower than June 30, 1997 levels.

- Obviously the telecommunications industry has undergone significant change throughout the 1990's. The impacts of economic, industry, business process, systems and personnel changes render any application of 1997 test results back to 1991 meaningless.

- The nature and amount of hardwired COE assets has changed significantly over time, from electromechanical to analog to digital switching technology, for example.

- Finally, and most importantly, no substantive tests were performed during the period from 1997 back to 1991 that provide the ASD any basis for applying the audit results back to prior periods.

Furthermore, Mr. Geppert states:

> As the ASD did not perform any audit tests covering the period from June 30, 1997 back to January 1, 1991, there is no basis to attribute its June 30, 1997 audit conclusions back to that date. Similarly, there is no basis to suggest that a rate reduction is required due to the Company's initial price cap rates being inflated.[56]

The preceding comments demonstrate that there is no basis for considering price cap adjustments or re-initialization as a result of the ASD's CPR audit findings.

III. AT&T AND MCI OFFER NOTHING TO DISCREDIT U S WEST's ARGUMENTS THAT THE ASD's STATISTICAL TECHNIQUES ARE FATALLY FLAWED

In its comments and earlier responses, U S WEST provided extensive comment on the validity of the ASD's sampling and estimation techniques. U S WEST will not repeat these comments. As was previously noted, U S WEST engaged Deloitte & Touche to review and comment on those portions of the ASD's draft audit reports relating to sampling and estimation techniques. Ann Thornton, Deloitte & Touche's "quantitative techniques" expert, provided extensive comment on both the ASD's July 20, 1998 and December 22, 1998 draft audit reports and identified twelve major concerns which called into question the validity of both the ASD's sampling and estimation techniques.[57] Only one of these concerns was addressed by the ASD in its December 22, 1998 draft audit report, and then only partially through the removal of an erroneous footnote.[58] Subsequently, Chairman Kennard provided further insight into the ASD's statistical techniques in his February 24, 1999 letter to Congressmen Tauzin and Dingell.[59]

U S WEST asked Ms. Thornton to review AT&T's and MCI's comments and Chairman Kennard's letter in light of her earlier observations.[60] Neither Chairman Kennard's letter nor AT&T and MCI's comments alleviate her prior concerns with the validity of the ASD's statistical techniques. Ms. Thornton states:

> In summary, because the new documents do not adequately respond to the observations made in our letters of August 18, 1998 and January 8, 1999, we continue to have concerns that the approach taken by the

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[56] Id. at 12.

[57] See Attachment 1.

[58] Other than that, it appears that the ASD's position was that no further comment or corrections were necessary.

[59] See Letter to The Honorable W.J. "Billy" Tauzin and The Honorable John D. Dingell from William E. Kennard, Federal Communications Commission dated Feb. 24, 1999. U S WEST only recently received a copy of Chairman Kennard's letter. If U S WEST had been in possession of a copy prior to filing its opening comments on the above-captioned Notice, it would have addressed Mr. Kennard's comments on the ASD's statistical techniques in its comments.

[60] Ms. Thornton's detailed response to U S WEST 's request is contained in Attachment 4.

> ASD may result in invalid sampling estimates. And, **we reiterate that, even if the estimate is in fact valid, the size of the precision range, because it is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population** [emphasis added]**.**[61]

In the interest of brevity, U S WEST will not address each of Ms. Thornton's continuing concerns or her detailed response to IXCs' comments which is contained in Attachment 4. U S WEST will limit its comments to five major concerns which seriously call into question the validity of the ASD's statistical techniques and render the ASD's estimates virtually meaningless for purposes of drawing conclusions with respect to the level of COE hardwired investment. These concerns are:

- The size of the precision range.
- The failure to use dollar-based selection techniques.
- The significance of the mid-point in the confidence interval.
- The failure to consider understatement errors.
- The number of strata and selections per strata.

It is U S WEST's opinion that there is not "one weak link," but many in the ASD's statistical techniques. The net result is that the ASD's audit is fatally flawed from the selection of the initial U S WEST sample to the ASD's estimate of "missing" hardwired COE investment.

[61] Attachment 4, Thornton Oct. 25, 1999 letter at 2.

A. Size Of The Precision Range

As early as August 19, 1998, U S WEST pointed out that the size of the precision range exceeded the ASD's estimate of "missing" COE investment. As Ms. Thornton observed in her August 18, 1998 letter, an estimate with such a wide precision range is of little or no value for predictive purposes.[62] In her most recent letter, Ms. Thornton states:

> Remarkably, Mr. Bell, Mr. Loebbecke, and AT&T (pp. 26-28) are <u>all silent on this key point</u>. Mr. Loebbecke, as discussed above, avoids discussing the statistical extrapolation entirely. Mr. Bell and AT&T discuss many aspects of the extrapolation, including a discussion of 95% confidence levels vs. 99% confidence levels (Bell p. 12, AT&T p. 27), degrees of freedom in the confidence interval calculation (Bell p. 11, AT&T p. 27), and symmetric vs. asymmetric confidence intervals (Bell pp. 11-12 , AT&T p. 28). These topics only have relevance in consideration of how the confidence interval should be computed.
>
> The following statement from my August 18, 1998 letter remains unanswered: "In this case, the total range of uncertainty is $394.8 million, which is larger than the estimate of $378.6 million. Typically, I would not expect that an estimate with such a wide precision range would be useful."[63]

The importance of this concern cannot be over-emphasized, particularly in light of the fact that no single point in the precision range is any more likely to occur than any other point from a statistical perspective.[64]

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[62] <u>See</u> Attachment 5, Letter to Ms. Kristine M. Ringsdorf, U S WEST, from Ann Thorton, Deloitte & Touche, LLP, dated Aug. 18, 1998 ("Thorton Aug. 18, 1998 letter").

[63] Attachment 4, Thornton Oct. 25, 1999, letter at 12.

[64] <u>See</u> Section C below and Attachment 4, Thornton Oct. 25, 1999 letter at 13-14.

B. The Failure To Use Dollar-Based Selection Techniques

To date neither the ASD nor commenters have adequately addressed the fact that the ASD's audit employed random sampling techniques for selecting CPR items without regard to their value. This is a serious flaw in an audit that covers items ranging in value from a few dollars to hundreds of thousands of dollars. In fact, Dr. Robert Bell, AT&T's statistical expert, acknowledges as much when he states: "This design [random sampling] was essentially optimal for estimating the proportion [not dollars] of missing RBOC hardwired central office equipment."[65] However, Dr. Bell continues on to assert that this design also "produced essentially unbiased point estimates for both the percentage of missing items and the total dollar amount of missing investment."[66] Ms. Thornton challenges Dr. Bell's claim and states:

> In our judgment, Mr. Bell's explanation demonstrates that the sample design was less than optimal for dollar estimates. If US West may be held accountable for a certain dollar amount of missing CPR items, it would be reasonable to set up a sample that would produce "optimal" dollar estimates, not optimal estimates of the proportion of missing items.[67]

U S WEST agrees.

C. Significance Of The Mid-Point In The Confidence Interval

Both AT&T and their statistical expert, Dr. Bell, stress the importance of the mid-point of a confidence interval (also referred to as the point estimate) for

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[65] Bell Affidavit at 5.

[66] Id. at 6.

[67] Attachment 4, Thornton Oct. 25, 1999 letter at 10-11.

predictive purposes. For example, Bell states: 'The best estimate for the amount of HWCOE that is missing is the point estimate."[68] Without referencing Dr. Bell but citing Wonnacott & Wonnacott, Introductory Statistics for Business and Economics, AT&T states: "The one number that is the best estimate of the true value, however, is the point estimate."[69] They are misinformed -- "sampling theory does not support the assertion that the actual cost of missing plant lies closer to the mid-point of the range."[70] In fact, AT&T's position is refuted by one of its own experts, Mr. Loebbecke who is a statistical expert in his own right,[71] as Ms. Thornton states citing Mr. Loebbecke:

> In fact, there is no best estimate in a confidence interval -- all points are equally likely from a statistical perspective. This is supported by Chapter 4 in *Applications of Statistical Sampling to Auditing* by James K. Loebbecke and Alvin Arens. In the section on statistical inference, the following statement is made: "the sample mean has no greater chance of exactly equaling the true but unknown population mean than any other value in the confidence interval."[72]

Thus, assuming arguendo that the ASD's statistical estimates are correct, the wide precision range renders them meaningless for any useful purpose -- given that all points within the precision range have an equal chance of occurring.[73]

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[68] Bell Affidavit at 13.

[69] AT&T at 25.

[70] Attachment 4, Thornton Oct. 25, 1999 letter at 2.

[71] Id. at 3.

[72] Id. at 13.

[73] Also see, Section III.A. supra.

D. The Failure To Consider Understatement Errors

This issue arose from the fact that the ASD's audit was a "one way" audit which was not designed to take into account items that may have been present in quantities greater than reflected in the DCPR. Neither the ASD nor commenters have satisfactorily addressed this issue other than to acknowledge that the audit was not designed with "completeness" as an objective[74] and to assert that it was in the RBOCs' self-interest to record COE on their books.[75] As Ms. Thornton observes:

> While these statements are correct, they do not directly address the question of why it was appropriate to perform a "one-way audit" that did not consider completeness and would not allow understatement errors to offset overstatement errors.[76]

The fact that the ASD conducted a one-way audit of limited scope implies that the ASD is equally limited in the conclusions that may be drawn from its audit. As Mr. Geppert notes in his discussion on the completeness of the ASD's audit:

> While the ASD's audit procedures may have detected CPR documentation issues, such findings can in no way be used to form a conclusion with respect to the fair presentation, in total, of COE account balances.[77]

U S WEST agrees with Mr. Geppert's conclusions and urges the Commission to limit the CPR audits to their original purpose -- determining compliance with the Commission's CPR recordkeeping requirements.

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[74] Loebbecke Affidavit at 8.

[75] Id. at 11.

[76] Attachment 4, Thornton Oct. 25, 1999 letter at 14.

[77] Attachment 2, Geppert Oct. 25, 1999 Declaration at 8.

E. The Number Of Strata And Selections Per Strata

AT&T and MCI and their experts defend the appropriateness of using a two-staged stratified sample.[78] However, they say nothing about the large number of strata (i.e., 11 in U S WEST's case) and the small number of selections per strata (i.e., as few as two for U S WEST). U S WEST has never challenged the appropriateness of using a two-staged stratified sample -- it has only raised concerns as to how this technique was applied in the U S WEST audit.

Ms Thornton first articulated this concern in her August 18, 1998 letter. She stated:

> I am concerned about the effect of the small number of sample selections from certain strata on the validity of the evaluation. For example, as few as 2 offices were selected within a stratum of offices. Moreover, only 33 offices were selected out of a population of 1131 offices. Typically, I would expect to see fewer strata with more selections per stratum. There is insufficient documentation in the Draft Audit Report to justify why so many strata with relatively small sample sizes within a strata might be expected to produce representative results.[79]

These concerns remain unaddressed by either the ASD or commenters. As a result, U S WEST continues to question this aspect of the ASD's audit and the "representativeness" of the sample used.

IV. THE ASD's "AFTER-THE-FACT" RESCORING STANDARD WAS NEITHER REASONABLE NOR FAIR

AT&T and MCI go to great lengths in arguing that the ASD's scoring/rescoring procedures not only were reasonable -- but were "overly generous"

[78] Loebbecke Affidavit at 3; Robert Bell Affidavit at 4; AT&T at 7.

[79] Attachment 5, Thorton Aug. 18, 1998 letter at 2.

to the RBOCs.[80] However, they fail to mention the fact that the ASD did not even reveal its very strict "probative evidence" standard for rescoring until almost 18 months after field audits were conducted. As such, AT&T and MCI can only be fantasizing when they claim that the ASD's rescoring procedures are fair and reasonable.

The "probative evidence" standard is neither reasonable nor valid as applied in the CPR audits. It appears to be a standard that was adopted after-the-fact to support the ASD's initial field audit findings. In its simplest form the methodology that the ASD auditors used to rescore their field audit results can only be described as a "gotcha." At no time prior to the release of the Rescore Public Notice (April 7, 1999), did the ASD provide the RBOCs with any indication as to the standard that would be used to modify field audit results or that the standard would significantly exceed that commonly-used under GAAS.[81] Thus, it is hardly surprising that the submissions of U S WEST and the other RBOCs failed to satisfy this "unrevealed" and "unanticipated" standard. As Mr. Geppert observes:

> It is no wonder that the ASD received a broad range of documentation requesting scoring changes, as the Company and other RBOCs were left to interpret such re-scoring criteria themselves. As authoritative auditing literature does not prescribe specific evidentiary standards for the evaluation of support documentation, the Company was left with

[80] AT&T at 13-15; MCI at 12, 14.

[81] As Mr. Geppert points out in his earlier Declaration: "The ASD's 'probative evidence' standard is not a term of art in the auditing profession and prescribes a standard over and above that suggested by GAAS [generally accepted auditing standards]." Attachment 2, Geppert Oct. 25, 1999 Declaration at 10.

> no other choice than to judgmentally evaluate the documentation accumulated and assess its reasonableness.[82]

The "probative evidence" standard fails on two levels. First, as Mr. Geppert explains in his Reply Declaration, this standard is not a reasonable standard to be used in performing audits.[83] Secondly, even if one assumes the reasonableness of the standard, the standard was not applied in a valid manner in the CPR audits. Mr. Geppert summarizes his evaluation of the ASD's rescoring methodology as follows:

> As a result, ASD's re-scoring standards and methodology were deficient with respect to the timing of their communications to the auditee, the restrictive and arbitrary use of the "probative evidence" standard, the disregard of pertinent authoritative standards for the determination of sufficient and competent evidential matter, and the failure of ASD to review internal controls in order to determine what evidence could be relied on. Such deficiencies render the re-scoring process and the audit results determined therefrom unreliable.[84]

U S WEST agrees with Mr. Geppert's evaluation.

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[82] Id. at 9.

[83] ". . . GAAS recognizes that the nature and extent of audit evidence will vary among audits and that proof 'beyond a reasonable doubt' will rarely be obtained. Thus, the ASD's 'probative evidence' standard in the real world will rarely, if ever, be achieved. What GAAS (as well as GAGAS) then directs the auditor to do is to obtain additional persuasive evidence -- not ignore the documentation supplied because it doesn't meet, in the ASD's interpretation, this arbitrarily high standard." Id. at 10.

[84] Id. at 10-11.

V. CONTRARY TO THE ASSERTIONS OF AT&T AND MCI, THE ASD's AUDIT PROCEDURES FELL FAR SHORT OF SATISFYING EITHER GENERALLY ACCEPTED AUDITING STANDARDS ("GAAS") OR GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS ("GAGAS")

AT&T's audit expert, Mr. Loebbecke states that the ASD's audit procedures fully complied with "applicable professional standards."[85] It is significant that he did not say that these procedures complied with GAAS or GAGAS.[86] He explains that the audits are special purpose audits that were intended to determine the correctness of the CPR -- not to determine whether the RBOC property accounts "conform to generally accepted or regulatory accounting principles.[87] He notes that under GAAS the CPR audits would be classified as "agreed-upon procedures" engagements.[88] Such special purpose audits neither comply with all GAAS or GAGAS standards nor do they allow auditors to draw conclusions with respect to COE account balances,[89] as Mr. Geppert notes in discussing Mr. Loebbecke's Affidavit:

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[85] Loebbecke Affidavit at 1.

[86] Loebbecke has chosen his words very carefully in stating: "Review of Generally Accepted Auditing Standards of the American Institute of Certified Public Accountants ("GAAS") and the Government Auditing Standards ("GAGAS") confirms that the FCC's audits were conducted in an acceptable professional manner." Id. at 8-9. Clearly, this is not the same as saying that the audits complied with all GAAS and GAGAS standards.

[87] Id. at 8.

[88] Id. at 8-9.

[89] Since Mr. Loebbecke has identified the CPR audits as "special purpose audits" with limited objectives, he is not incorrect when he states: "My review of the staff's audit procedures indicates that the **appropriate** [emphasis added] GAAS and GAGAS were at all times complied with by the audit staff." Loebbecke Affidavit at 10. Clearly, this as a very "qualified" endorsement of the ASD's audit procedures.

> First, Mr. Loebbecke correctly observes that the ASD's audits were not performed in accordance with GAAS with the intent to conclude as to the fair presentation of COE plant account balances. Such a conclusion can only be rendered based on an audit performed in accordance with **all** GAAS standards and not selected standards. Neither a special purpose audit with limited scope or purpose nor an agreed-upon procedures engagement meets the GAAS standards necessary to render such a conclusion. In other words, conclusions drawn with respect to the fairness of the COE account balances can only be made based on audits performed in accordance with **all** GAAS standards and cannot be made based on the audit procedures performed by the ASD.
>
> Second, it is significant that completeness was not an objective of the ASD's audit. As Mr. Loebbecke stated in his affidavit, the audit was directed only at determining the correctness of the CPR via the attempted verification of assets listed on that CPR. This objective cannot be confused with the much more comprehensive objective of determining the fair presentation of the Company's hardwired COE account balances.
>
> Third, agreed-upon procedures ("AUP") engagements are **not** audits performed in accordance with GAAS (or GAGAS).[90]

Since the ASD's audit was never designed to render an opinion "relating to the fair presentation of the specified elements, accounts, or items of a financial statement," the ASD's recommendation to write-off $378.6 million of hardwired COE and $218.6 million of undetailed investment on U S WEST's books of account cannot be supported.[91]

Furthermore as Mr. Geppert states:

> GAAS requires the auditor to investigate all information that he or she becomes aware of, including information provided by management, during the audit process. With respect to all information provided, the auditor must determine:

[90] Attachment 2, Geppert Oct. 25, 1999 Declaration at 4.

[91] Id.

- Whether the information is reliable and factual,
- If the facts existed at the date of the audit report and whether it is likely that users or likely users of the report would attach importance to the new information, and
- Whether appropriate disclosures of such facts should be made to the users or likely users of the audit report. If the effect on the financial statements or auditor's report of the information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report.[92]

Clearly, these determinations were never made by ASD. It appears that the ASD largely ignored management input, as U S WEST pointed out in its comments.[93] ASD's position can be summarized as follows: 1) if its auditors could not find a CPR item on the single day that they visited a central office and 2) if an RBOC did not satisfy the ASD's unreasonably restrictive after-the-fact "probative evidence" standard -- then the item did not exist. While such an arbitrary approach may serve the ASD's internal purposes, it cannot be reconciled with GAAS, GAGAS, or conventional auditing practices as Mr. Geppert notes:

> An audit is not a "one chance and one chance only" proposition, however. To the extent that management was able to find the sampled equipment subsequent to the auditors' field work or obtained reasonable support documentation to refute a "not found" determination, such additional evidence should be considered in the same light that the physical verification results were considered. **It is inconceivable and contrary to conventional auditing practices that the ASD staff did not perform follow-up field visits in order to verify hardwired COE that was found subsequent to their one-day visit.**[94]

[92] Id. at 5.

[93] U S WEST Comments at 4.

[94] Attachment 2, Geppert Oct. 25, 1999 Declaration at 5.

It should also be noted that the ASD's audit procedures fail to distinguish between inventories of goods that are sold to third parties and inventories of fixed assets that a business uses to produce goods and services for sale to others. While inventories of goods for sale to third parties (e.g., groceries) may turnover quickly, fixed assets (e.g., hardwired COE) are likely to remain in service for long periods time. This fact, if anything, should have compelled follow-up field visits by the ASD during the course of the CPR audits.

While Mr. Loebbecke references many GAGAS standards that are applicable to the ASD's audit,[95] as Mr. Geppert points out that the audit did not comply with a number of other critical GAGAS requirements including the following:[96]

- Auditors should obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing and extent of tests to be performed.[97]
- Auditors should establish clear criteria used to determine whether audit objectives are achieved.[98]
- "Auditors should report the views of responsible officials…concerning auditors' findings, conclusions and recommendations."[99]

Additionally, GAGAS requires that the auditor evaluate management's comments on the audit findings and "***modify the findings if necessary***."[100]

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[95] Loebbecke Affidavit at 10.

[96] Attachment 2, Geppert Oct. 25, 1999 Declaration at 6.

[97] Government Auditing Standards: 1994 Revision, issued by the United States General Accounting office, Comptroller General of the United States (June 1994) ("Yellow Book"), ¶ 4.21.

[98] Id. ¶ 6.11.

It bears repeating that, as Mr. Loebbecke states: "Completeness was not an objective, as no tests of completeness were included in the audit plan."[101] Since the CPR audit was never designed to do anything other than determine compliance with the CPR's recordkeeping requirements, it is both inappropriate and a violation of GAAS to draw conclusions with respect to COE account balances.[102] If the audit had been designed with "completeness" as an objective, it surely would have included tests for both over- and understatements (i.e., a "two-way" audit).[103] As Mr. Geppert states:

> While the ASD's audit procedures may have detected CPR documentation issues, such findings can in no way be used to form a conclusion with respect to the fair presentation, in total, of COE account balances.[104]

In summary, the CPR audit was a special purpose audit with limited objectives. As such, it was not designed to, nor performed in accordance with, all GAAS and GAGAS standards. However, the ASD would been on firmer ground if it had restricted its audit findings and recommendations to compliance with the Commission's recordkeeping requirements. Unfortunately, it did not. The ASD went far beyond its limited objectives and drew conclusions which have no basis in

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[99] Id. ¶ 7.38.

[100] Attachment 2, Geppert Oct. 25, 1999 Declaration at 7.

[101] Loebbecke Affidavit at 8.

[102] Attachment 2, Geppert Oct. 25, 1999 Declaration at 9.

[103] Id. at 8.

[104] Id. at 8.

fact and are unsupported by either GAAS, GAGAS, or sampling theory. As Mr. Geppert states:

> The ASD's audit procedures were deficient with respect to the use of generally accepted auditing standards ("GAAS") and/or generally accepted government auditing standards ("GAGAS") and do not provide a reasonable basis for rendering an opinion as to the fair presentation, in all material respects, of the COE plant investment balance.[105]

VI. THE CONTINUED USE OF UNDETAILED INVESTMENT DOES NOT VIOLATE PART 32 AND IS A REASONABLE MEANS OF TRACKING COE EQUIPMENT REQUIRING FURTHER DETAILING

In 1968, AT&T began the process of converting existing Central Office Equipment Data to a new Property Record System (i.e., PICS/DCPR). U S WEST's predecessor companies (i.e., Mountain Bell, Northwestern Bell, and Pacific Northwest Bell) did not begin converting their Property Record System to this system until 1977. Prior to this time, hardwired COE equipment was not detailed by specific CPR numbers. All of this equipment was initially classified as "undetailed" equipment with a CPR number of 040000 until such time the equipment (through the process of inventories) could be detailed. AT&T's own "Bell Systems Practices" indicate that "detailing" of the majority of hardwired COE investment was expected to take approximately 15 years (i.e., ending in 1990).[106] Thus, neither the Commission nor AT&T should be surprised to find a small

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[105] Id. at 1.

[106] See Bell System Practices, AT&T Co. Standard, "General Description PICS/DCPR System," Section 790-100-120, Issue 1, December 1978. Also see Attachment 6 which contains a chart from this BSP indicating the anticipated time period necessary to detail hardwired COE equipment.

amount of undetailed COE equipment that predates the implementation of the PICS/DCPR system.

In addition to the above explanation for the existence of undetailed investment, U S WEST has utilized the undetailed category "as a repository to store capitalizable costs until they can be recorded in the proper categories" in the DCPR system.[107] An example of how the undetailed category may be used is in the case of newly-purchased equipment which doesn't have a CPR number. In such instances, the equipment may be given the CPR number of 040000 (i.e., "undetailed")[108] until such time that the equipment can be detailed with the correct CPR number which describes the specific type of equipment (e.g., 5ESS Power Distribution Frame --

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[107] Attachment 2, Geppert Oct. 25, 1999 Declaration at 13.

[108] Also, U S WEST may assign this number to a COE package which is comprised of multiple property record units but is ordered and placed as a single unit. In such cases, the vendor's bill may not contain a CPR number and the numbers for the individual property record units must be assigned manually if they exist. If CPR numbers have not been previously established for each of the property record units the vendor will be asked to obtain CPR numbers from Telcordia (i.e., the entity which maintains the PICS/DCPR Master Catalog). For example, U S WEST may order and install a "SPX-Bay 159,"a certain type of equipment bay, as a single unit and assign the investment to the undetailed category. When the "detailed" information is provided on this bay, the CPR would reflect the following individual property record units:

Item	Qty	Description	List	Total	CPR#
1	1	11.5' UEF Rack	$455.40	$ 455.40	Minor Item 99999
2	1	2" x23" Blank Panel	9..90	9.90	Minor Item 99999
3	2	Fuse Panel 8 Pos.	483.00	966.00	467783 Panel
4	5	CHAS LPEX 28 Pos. 6X23PW	400.00	2,000.00	004857 Shelf
5	1	CAFF HEAT LPEX 4X23PW	200.00	200.00	Minor Item 99999
6	4	PNLLPEX PLENUM Fiber Mgt	200.00	800.00	467687 Panel
7	1	PNL FAN SPX UNIV 4X23 PW	300.00	300.00	467690 Panel
8	2	Fuse KLM 2 AMP	10.00	20.00	Minor Item 99999
9	10	Fuse KLM 20 AMP	10.00	100.00	Minor Item 99999
10	1	CT800 Access Concentrator	5,400.00	5400.00	136387 Unit
11	1	5" Guard Box	349..93	349.93	Minor Item 99999

CPR No. 109076).[109] As a result, the total dollars assigned to the undetailed category is changing constantly as equipment is moved in and out of the category (i.e., as detailing occurs). As Mr. Geppert points out in his Declaration: "Amounts included in the undetailed category are recorded in the proper general ledger plant account, in the proper vintage year and wire center, but are awaiting the necessary detail to assign the appropriate equipment CPR number."[110]

Thus, U S WEST uses the undetailed category as a "clearing account" within the CPRs to hold hardwired COE investments until they can be identified with specificity. There is no basis for the assertion that continued use of the undetailed category in some way violates the Commission's Part 32 Rules.[111] As Mr. Geppert states: "This process is perfectly reasonable for U S WEST to follow, as it is consistent with the FCC's prescribed use of clearing accounts in Part 32 of it Rules and Regulations."[112] U S WEST has fully explained its use of the undetailed

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[109] If equipment is invoiced by a vendor without a Telcordia (i.e., formerly Bellcore) CPR number, the vendor must then submit an application (i.e., with a fee) to Telcordia to establish a new CPR number. In the meantime the equipment is assigned CPR No. 040000 until such time the detailed CPR number is established in Telcordia's Property Record Catalog. Currently, there are approximately 300,000 line items in the PICS/DCPR Master Catalog.

It should be noted that increasing amounts of equipment are being purchased from vendors without CPR numbers. There are numerous reasons for this including: 1) the number of telecommunications equipment vendors has grown substantially in recent years; 2) technology and, thus, equipment, is rapidly evolving -- with decreasing equipment life cycles; and 3) vendors simply don't want to spend the money to get equipment included in the Telecordia CPR catalog unless it is required.

[110] Attachment 2, Geppert Oct. 25, 1999 Declaration at 13.

[111] AT&T at 37-38; MCI at 28-31.

[112] Attachment 2, Geppert Oct. 25, 1999 Declaration at 13-14.

category in its comments and response to the ASD's draft audit report.[113] Furthermore, no amounts have been inappropriately assigned for regulatory purposes as result of U S WEST's use of the undetailed investment category. As such there is no basis for the ASD's recommendation or AT&T and MCI's assertions that U S WEST should write-off $218.6 million from its COE accounts.[114] Mr. Geppert concurs with this view and urges the Commission to reject the ASD's recommendation:

> As of June 30, 1997, U S WEST had approximately $218.6 million in the undetailed investment category. Based on information provided to AA by U S WEST, as of December 1998, U S WEST had cleared all but $1.7 million of the original June 30, 1997 undetailed investment (not including the nonregulated plant discussed above) to the proper DCPR categories. By August 31, 1999, the balance in undetailed investment was approximately $23 million (including certain nonregulated plant investment), thereby demonstrating the fluctuating nature of this category. Thus, at the current time, there are no significant regulated COE investment dollars from June 30, 1997 in the undetailed investment category to write-off and the ASD's recommendation should be rejected.[115]

VII. CONCLUSION

As U S WEST demonstrated in its comments and the foregoing reply, the ASD's audit of U S WEST's CPR for hardwired COE is fatally flawed. As such, there is no basis to support the ASD's finding or for the Commission to take any actions on these flawed findings. Furthermore, the ASD's audit was a "special

[113] See Letter to Mr. Ken Ackerman, Chief, Audits Branch from Kathleen Q. Abernathy, dated Aug. 19, 1998 and the attached U S WEST, Inc.'s Response to Draft Audit Findings; Audit of Continuing Property Records at 12-14.

[114] MCI at 27-28; AT&T at 38-39.

[115] Attachment 2, Geppert Oct. 25, 1999 Declaration at 14.

purpose audit" which was never designed to and does not provide a reasonable basis for drawing any conclusions with respect to U S WEST's COE account balances.

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October 25, 1999

ATTACHMENT 1

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January 8, 1999

Mr. Mark A. Schumacher
Executive Director – Accounting Operations
US WEST, Inc.
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Dear Mr. Schumacher:

Deloitte & Touche LLP was asked by US West, Inc. to read and provide comments on the sampling methodology described in the draft FCC Accounting Safeguards Division ("ASD") report, "Audit of Continuing Property Records of US West as of June 30, 1997; Report of Audit Findings" (the "June ASD Report"). We provided US West with a letter containing our comments dated August 18, 1998. A copy of that letter is attached hereto.

You have now asked us to read the December 22, 1998 draft of the "Audit of Continuing Property Records of US West as of June 30, 1997; Report of Audit Findings" (the "December ASD Report") and provide comments on the ASD's response to our observations about the ASD's sampling methodology that we made in our August 18, 1998 letter (which included several concerns that could affect the validity of the estimates).

Based on our reading, the December ASD Report does not address the observations in our August 18, 1998 letter which are most relevant to our summary stated in that letter, which is reiterated herein: *In summary, given the several questions and concerns about the sampling approach taken by the ASD, it is possible that the resulting sampling estimates may be invalid (i.e., the range of the estimate does not contain the actual amount of error in the population). Additionally, even if the estimate is in fact valid, the size of the precision range, which is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.*

We have numbered the observations made in our August 18, 1998 letter (see attached letter) to facilitate the presentation of the basis for our conclusion that the December ASD Report does not address our August 18, 1998 observations which are most relevant to the summary presented above, as follows.

No.	D&T Observation on June ASD Report	ASD Response to D&T Observation	D&T Comment on December ASD Report
1	Criteria used to exclude over 500 offices from population was not explained.	No acknowledgement of observation or any response thereto.	We reiterate our August observation.
2	The process used to replace certain original sample selections was not documented.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
3	The rationale for using a high number of strata, with relatively few selections per strata was not documented.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
4	The explanation of sample design did not address the choice of the number of offices and the stratification of offices.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
5	Random selection based on units was used, rather than dollar-based sampling, which is more typically used when evaluating the value of acounting populations, especially populations in which the value of individual items varies widely.	No acknowledgement of observation or any response thereto.	We reiterate our August observation

6	The precision range was very large, reducing the predictive value of the estimate of error in the population.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
7	There was not any reference to sampling guidelines for precision.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
8	Documentation was not provided for why mean-per-unit estimators were used, instead of ratio estimators (mean-per-unit estimators usually result in a larger precision range)	No acknowledgement of observation or any response thereto.	We reiterate our August observation
9	Sampling theory does not support the assertion that the actual cost of missing plant lies closer to the mid-point of the range.	Footnote 39 of the June ASD Report, which contained the assertion, has been removed.	The assertion continues to be made – see footnote 27 and pp. 12-13 of the December ASD Report. We again note that any individual sampling estimate within a precision range should be considered to be equally likely of being the actual amount of error.
10	Accounting standards do not support using the high end of a range, when all points in the range are equally likely of being the actual error.	Comment removed.	Response resolves our observation.

11	Understatement errors were not considered as an offset to the findings that the population may be overstated.	No acknowledgement of observation or any response thereto.	We reiterate our August observation

Additionally, we noted that the December ASD Report, in Appendix B, included additional results, which were said to be based on a Bayesian approach. However, we note that the discussion presented only results. It did not include formulas, calculations or other information that would be necessary for us to comment on the results presented. Given that there is not just one Bayesian approach, but rather a family of Bayesian approaches and analyses that can be executed in different ways, it is impossible to evaluate the Bayesian results presented in the December ASD Report.

Because the December ASD Report is not responsive to the observations made in our August 18, 1998 letter, we continue to have concerns that the sampling approach taken by the ASD may result in invalid sampling estimates. And, we reiterate that, even if the estimate is in fact valid, the size of the precision range, because it is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.

Yours truly,

Ann Thornton

Ann Thornton, Director
National Director – Data Quality and Intergrity Service Line

ATTACHMENT 2

REPLY DECLARATION OF CARL R. GEPPERT

I, CARL R. GEPPERT, declare that:

I am a Certified Public Accountant and a partner of Arthur Andersen LLP ("AA"). My business address is 1225 17th Street, Suite 3100, Denver, Colorado 80202. I am a member of a group at AA that provides audit, tax and consulting services to clients in the communications industry.

During my 19-year career, I have been almost exclusively involved in financial, regulatory and cost accounting matters in the telecommunications and utilities industries. I have served as an auditor for and consultant to clients in the telecommunications industry and currently direct my firm's telecommunications industry practice in the areas of regulatory accounting, auditing and consulting. I am our Firm's representative on the Telecommunications Subcommittee of the Public Utilities Committee of the AICPA.

PURPOSE AND SCOPE OF DECLARATION

This declaration will address certain issues raised in the comments of several parties in response to the Notice of Inquiry[1] and the related Public Notice[2] released by the Federal Communications Commission ("FCC") Common Carrier Bureau's ("Bureau") Accounting Safeguards Division ("ASD") on April 7, 1999. The issues this declaration will address relate to the audit and re-scoring procedures employed by the ASD in its audit of the continuing property records ("CPRs") of hardwired central office equipment ("COE") at the Regional Bell Operating Companies ("RBOCs"), including U S WEST, Inc. ("U S WEST" or the "Company"). The results of such audit, together with the Company's comments, were publicly released on March 12, 1999.[3] Specifically, I will address the following issues:

- <u>Sufficiency of the ASD's Audit Procedures.</u> The ASD's audit procedures were deficient with respect to the use of generally accepted auditing standards ("GAAS") and/or generally accepted government auditing standards ("GAGAS") and do not provide a reasonable basis for rendering an opinion as to the fair presentation, in all material respects, of the COE plant investment balance. The conclusions reached and recommendations offered by the ASD in its Audit Report cannot be relied upon - such conclusions and recommendations can only be made based on comprehensive audits performed in accordance with authoritative standards and practices.

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[1] *In the Matter of U S WEST Telephone Companies' Continuing Property Records Audit*, Notice of Inquiry, CC Docket No. 99-117, FCC 99-69 (rel. April 7, 1999), [hereinafter Notice of Inquiry]; DA 99-1072, rel. June 2, 1999; DA 99-1321, rel. July 2, 1999; DA 99-1855, rel. September 10, 1999.

[2] *The Accounting Safeguards Division Releases Information Concerning Audit Procedures for Considering Requests by the Regional Bell Companies to Reclassify or "Rescore" Field Audit Findings of their Continuing Property Records*, Public Notice, DA 99-668 (rel. April 7, 1999), [hereinafter Public Notice].

[3] *Audit of the Continuing Property Records of U S WEST Telephone Operating Companies - As of June 30, 1997* (rel. March 12, 1999), [hereinafter Audit Report].

- ASD's Methodology Used to Re-score "Not Found" Items. The procedures followed by ASD to score and re-score items as "not found" were **not** biased in favor of the RBOCs, including U S WEST. The ASD's re-scoring process focused only on the gathering of "probative evidence," a restrictive and arbitrary standard, and did not take into account several aspects of GAAS or GAGAS necessary to render a fair evaluation of the COE account balances. Such critical deficiencies included ignoring evidential matter obtained from independent sources and the failure to review internal controls over the hardwired COE CPR process in order to properly determine the validity and reliability of the numerous types of supplemental evidence submitted to the ASD by the Company.

- Attribution of Audit Results to Prior Periods. There is **no basis** under GAAS or GAGAS to attribute the results of the ASD's physical verification procedures to prior periods. The results of an audit procedure, such as a physical verification of COE assets, can only be used to form conclusions with respect to the account balances audited as of the audit date (June 30, 1997). This is particularly true given that the ASD did not perform any audit procedures, such as tests of internal controls over hardwired COE that would enable them to assess the sufficiency or deficiency of the Company's business processes and controls over hardwired COE over time.

- Allegations of "Phantom Plant." The comments that allege the Company has recorded hundreds of millions of dollars in hardwired COE that was in fact never placed in service[4] are unfounded. There is no evidence to support this "phantom plant" contention, primarily because the ASD audit never addressed the Company's internal controls, methods and procedures with respect to the hardwired COE procurement process. The ASD's physical verification procedures, even if performed properly and completely, were insufficient to determine the cause of missing hardwired COE, if any.

- Accounting Corrections Related to Undetailed Investment. The Company should **not** write-off its undetailed investment as this category functions as a "clearing category" where COE costs can be captured pending proper categorization in the CPRs. As the ASD's physical verification took place at an interim date in 1997 (June 30, 1997), a balance in the undetailed investment category is to be expected. This category will be cleared out and added to throughout the year and should be reviewed during the annuals process.

These deficiencies, together with the deficiencies identified in the Company's original comments in this proceeding and highlighted in my Declaration included as Attachment 1 to those comments ("Prior Declaration"), show that the ASD's audit procedures,

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[4] See *In the Matters of Ameritech Corporation Telephone Operating Companies', et al Continuing Property Records Audits*, Comments of AT&T Corp., CC Docket No. 99-117, ASD File No. 99-22, rel. September 23, 1999, [hereinafter AT&T Comments], page 30, and Comments of MCI WorldCom, Inc., CC Docket No. 99-117, ASD File No. 99-22, rel. September 23, 1999, [hereinafter MCI WorldCom Comments], Attachment 2: Snavely King Report, pages 4-5.

conclusions and recommendations are flawed and cannot be relied on to form an opinion on the fair presentation of the Company's COE account balances. I will not repeat the issues previously covered in my Prior Declaration -- rather, I will expand on such areas in sufficient detail to address the issues raised in the comments to the Notice of Inquiry.

SUFFICIENCY OF THE ASD'S AUDIT PROCEDURES

Analysis of Authoritative Auditing Standards

The ASD states in its Public Notice that the audit was conducted in conformance with GAGAS, which are claimed to be comparable to GAAS. This position is explained further in the Affidavit of James K. Loebbecke ("Loebbecke Affidavit"), included as Exhibit C to the AT&T Comments.

In his affidavit, Mr. Loebbecke states that the ASD's audit procedures "fully complied with ***applicable professional standards*** [emphasis added]."[5] In explaining the meaning of "applicable professional standards," Mr. Loebbecke states:

> Thus, the audits have two specific objectives: compliance and accuracy. In terms of the latter objective, it is clear from the procedures planned and performed by the staff that accuracy was defined as existence of the assets and correctness of the CPR. Completeness was not an objective, as no tests of completeness were included in the audit plan. Consequently, these audits would best be described as special purpose audits with limited scope and purpose, as opposed to comprehensive audits of Bell Atlantic's property accounts to determine whether they conform to generally accepted or regulatory accounting principles.[6]

In comparing the ASD's audits to GAAS and GAGAS standards, Mr. Loebbecke further notes that "GAAS provide for engagements of similar scope to the staff's audit, called "agreed-upon procedures" engagements. GAAS make it clear that such engagements should be conducted under the general GAAS standards and the first standard of field work."[7] Mr. Loebbecke also cites several GAGAS standards that he claims were followed during the ASD's audits.[8]

The limited scope of the ASD's audits was also noted in the AT&T Comments. In footnote 10 of page 22, AT&T notes:

> In light of the ***narrow focus*** [emphasis added] of the Staff's inquiry, the Staff's audit is best described as special purpose audit, rather than a comprehensive audit of the RBOCs property accounts.[9]

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[5] Loebbecke Affidavit, ¶ 2.
[6] Loebbecke Affidavit, ¶ 14.
[7] Loebbecke Affidavit, ¶ 15.
[8] Loebbecke Affidavit, ¶ 16.
[9] AT&T Comments, p. 22 (footnote 10).

The above observations are significant in many respects.

First, Mr. Loebbecke correctly observes that the ASD's audits were not performed in accordance with GAAS with the intent to conclude as to the fair presentation of COE plant account balances. Such a conclusion can only be rendered based on an audit performed in accordance with **all** GAAS standards and not selected standards. Neither a special purpose audit with limited scope or purpose nor an agreed-upon procedures engagement meets the GAAS standards necessary to render such a conclusion. In other words, conclusions drawn with respect to the fairness of the COE account balances can only be made based on audits performed in accordance with **all** GAAS standards and cannot be made based on the audit procedures performed by the ASD.

Second, it is significant that completeness was not an objective of the ASD's audit. As Mr. Loebbecke stated in his affidavit, the audit was directed only at determining the correctness of the CPR via the attempted verification of assets listed on that CPR. This objective cannot be confused with the much more comprehensive objective of determining the fair presentation of the Company's hardwired COE account balances.

Third, agreed-upon procedures ("AUP") engagements are **not** audits performed in accordance with GAAS (or GAGAS). In fact, the auditor performing an AUP engagement may not render an opinion of any kind based on the results of his or her work. In an AUP engagement, "the accountant does not perform an audit and does not provide an opinion or negative assurance relating to the fair presentation of the specified elements, accounts, or items of a financial statement. Instead, the accountant's report on agreed-upon procedures should be in the form of procedures and findings."[10] In other words, the auditor's work is not planned or performed with the objective of rendering an opinion on the fairness of presentation of the accounts or account balances in question; thus, no such opinion can be rendered. Specifically in the case of the ASD's audit of the Company, recommendations to write-off investment, including $378.6 million of hardwired COE and $218.6 million of undetailed investment (in order to, in the ASD's opinion, fairly state U S WEST's hardwired COE account balances), cannot be supported by the type of engagement performed by the ASD.

<u>**Audit Evidence and Communications with Management**</u>

It is also telling to examine the GAAS standards that were omitted from Mr. Loebbecke's affidavit and the ASD's audit process. Specifically, the following GAAS standard of fieldwork should be noted:

> Standard of Field Work No. 3 - Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford

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[10] AICPA, Statements on Auditing Standards, AU Section 622: Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement, "Engagements to Apply Agreed-Upon Procedures."

a reasonable basis for an opinion regarding the financial statements under audit.[11]

GAAS requires the auditor to investigate all information that he or she becomes aware of, including information provided by management, during the audit process. With respect to all information provided, the auditor must determine:

- Whether the information is reliable and factual,

- If the facts existed at the date of the audit report and whether it is likely that users or likely users of the report would attach importance to the new information, and

- Whether appropriate disclosures of such facts should be made to the users or likely users of the audit report. If the effect on the financial statements or auditor's report of the information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report.

In other words, an important source of audit evidence is Company management. As the ASD auditors were only in the field one day per central office location, it is conceivable that not all assets could be located or physically verified. An audit is not a "one chance and one chance only" proposition, however. To the extent that management was able to find the sampled equipment subsequent to the auditors' field work or obtained reasonable support documentation to refute a "not found" determination, such additional evidence should be considered in the same light that the physical verification results were considered. **It is inconceivable and contrary to conventional auditing practices that the ASD staff did not perform follow-up field visits in order to verify hardwired COE that was found subsequent to their one-day visit.**

During the ASD's audit process, communications were extremely limited thus depriving the ASD of the benefits of management's insight and input to the audit process and results. Only upon the insistence of the RBOCs were draft audit results released in July 1998.[12] Even then the ASD did not permit any open dialogue between the ASD and the RBOCs, as the RBOCs were permitted only to:

- "Comment on the specific findings addressed in the enclosed draft report and listings, limited to correction of factual errors or omissions"[13] in response to the ASD's July Report, and

- "Provide specific comment on the enclosed audit report, limited to a total of 50 pages (including attachments, if any)"[14] in response to the ASD's December Report.

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[11] AICPA, Statements on Auditing Standards, AU Section 326: Evidential Matter.
[12] It should be noted that the individual RBOCs were required to sign a restrictive Non-Disclosure Commitment in order to obtain copies of their draft audit reports.
[13] FCC Draft Audit Report, "Audit of the Continuing Property Records of U S WEST As of June 30, 1997, Report of Audit Findings" issued July 20, 1998 (hereinafter referred to as the "July Report").

This "dialogue," which occurred only upon the insistence of the Company and the other RBOCs[15], was not the two-way communication necessary to interpret and resolve audit findings and conclusions in this complex area.

Generally Accepted Government Auditing Standards

GAGAS does prescribe relevant standards pertaining to audit quality and the characteristics of professional and meaningful audit reports. Mr. Loebbecke cites several GAGAS standards that were applicable to the ASD's audits. However, GAGAS as codified in Government Auditing Standards,[16] also specifies the following critical requirements, among others, that were not followed by the ASD in conducting its CPR audits:

- Auditors should obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing and extent of tests to be performed.[17] These CPR audits consisted solely of the physical verification of certain hardwired COE items from the CPRs - the Company's internal controls over COE plant assets were not considered in determining the nature, timing and extent of audit tests to be performed.

- Auditors should establish clear criteria used to determine whether audit objectives are achieved. Criteria provide a context for understanding the results of an audit. The audit plan, where possible, should state the criteria to be used.[18] Despite repeated requests by the RBOCs, the ASD never disclosed its audit standards or criteria used to assess whether assets were "found" or "not found" until the release of the Public Notice on April 7, 1999 (almost one and a half years after the dates of the physical verifications and one month after the release of the Audit Report). If the ASD's scoring and re-scoring criteria were known in advance, as is the normal procedure in conducting an audit, the Company could have gathered the appropriate audit evidence in accordance with such requirements.

- "Auditors should report the views of responsible officials…concerning auditors' findings, conclusions and recommendations."[19] These rules go on to state that, "One of the most effective ways to ensure that a report is fair, complete, and objective is to

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[14] FCC Draft Audit Report, "Audit of the Continuing Property Records of U S West Telephone Operating Companies As of June 30, 1997" issued December 22, 1998 (hereinafter referred to as the "December Report").

[15] See Letter to Ms. Kathryn C. Brown, Chief, Common Carrier Bureau from Kathleen Q. Abernathy, U S WEST, Inc. dated July 2, 1998 at Arthur Andersen attachment (Letter to Ms. Kristine M. Ringsdorf, U S WEST, Inc. dated June 26, 1998, from Carl R. Geppert).

[16] Government Auditing Standards: 1994 Revision, issued by the United States General Accounting Office, Comptroller General of the United States (June 1994) [hereinafter Yellow Book].

[17] Yellow Book, ¶ 4.21.

[18] Yellow Book, ¶ 6.11

[19] Yellow Book, ¶ 7.38

obtain advance review and comments by responsible auditee officials and others, as may be appropriate. Including the views of responsible officials produces a report that shows not only what was found and what the auditors think about it but also what the responsible persons think about it and what they plan to do about it."[20]

In addition, these rules require the auditor to evaluate management's comments on the audit findings and ***modify the findings if necessary***. As discussed below, the ASD set a standard requiring any additional evidence to have "strong probative value equal to the physical inspection evidence."[21] The Company in response to the ASD's audit findings submitted extensive documentation. At a minimum, this additional documentation, whether it met the ASD's "probative evidence" standard or not, should have caused the ASD to perform additional audit procedures to validate or invalidate such information, including follow-up visits by the ASD to certain central offices to validate this additional evidence and/or follow-up discussions with U S WEST personnel.

Analysis of the Adequacy and Completeness of ASD's Audit Procedures

Our analysis of the adequacy and completeness of ASD's audit procedures was contained in Attachment 1 to the Company's response to the December Report[22] and repeated in my Prior Affidavit. This analysis was not disputed in any way in the original comments in this proceeding and will not be repeated here.

Lack of a "Two-Way" Audit

One area that was addressed in comments to this proceeding, however, was the need for the ASD to perform a "two-way" audit, considering both possible understatement as well as overstatement of the COE account balances. The ASD's physical verification procedures were solely directed at detecting instances of potential overstatement in the plant accounting records. Instances of potential understatement were not considered. In other words, the ASD's physical testing procedures would only reveal instances where COE items included on the June 30, 1997 CPRs were not in the specified location as detailed in such CPRs. A comprehensive test of the physical existence of plant assets would not only consider instances of potential overstatement, but would include procedures such as the selection of assets in the respective central offices and the tracing of such assets to the CPRs to ensure that the CPRs are not understated. Only by testing for both potential over- and understatements (i.e., a "two-way" audit) can one begin to form the basis for concluding as to the propriety of the COE account balances.

Mr. Loebbecke discusses the "two-way" audit issue on page 11 of his affidavit. In his discussion, Mr. Loebbecke notes that "the staff's audit was a special purpose audit,

[20] Yellow Book, ¶ 7.39.
[21] Public Notice, p. 2.
[22] See Attachment 1, Declaration of Carl R. Geppert of Arthur Andersen LLP" dated January 9, 1999, to "U S WEST, Inc.'s Response to Draft Audit Findings, Audit of Continuing Property Records," dated January 11, 1999 (hereinafter referred to as the "U S WEST Response").

not a comprehensive GAAP audit. It was designed only to estimate the amount of equipment on the books that is missing, not the equipment present but not on the books, and the staff properly recommended only that Bell Atlantic write off the missing equipment, not that Bell Atlantic forego recording presently unrecorded items that they could determine at any time."[23] This statement is a creative play on words. As the ASD's audit was not a comprehensive audit designed to render a conclusion with respect to the fairness of the Company's COE account balances, recommendations that the Company adjust its property accounts not only should not be made, they cannot be made. To the extent that the Company were to write-off the allegedly missing equipment as the ASD and Mr. Loebbecke recommend, such resultant account balances would then most certainly fail the "fairly presents" standards in accordance with GAAP. Write-ons would then most certainly be required to restate the overall plant balances for "comprehensive GAAP purposes."

The arguments against the performance of a "two-way" audit dismiss the need to consider the possibility of understatement of the CPRs. Mr. Loebbecke states that "Intuitively, it is unlikely that Bell Atlantic would have failed to record significant amounts of equipment on its books, because those records are used to determine the rates Bell Atlantic can charge for its services."[24]

Regardless of whether Mr. Loebbecke's intuitive observation makes any sense or not (based on my experience I don't believe it does), there may be many reasons that the CPRs do not exactly reflect the specific assets placed in-service. In addition to the possibility that plant assets were never recorded, which I agree is a remote possibility, there exists the real possibility that clerical and/or timing errors exist in the CPRs, in the documentation processed to record asset retirements, or in the input of such documentation in the property records system. In other words, the auditors may have been looking to physically verify assets that existed but were incorrectly described on the CPRs. Or perhaps, when a large retirement job was processed, too many assets were retired in error. Only testing from the central office floor back to the CPRs could have found these situations (i.e., a "two-way" audit). While the ASD's audit procedures may have detected CPR documentation issues, such findings can in no way be used to form a conclusion with respect to the fair presentation, in total, of COE account balances.

ASD's METHODOLOGY USED TO RE-SCORE "NOT FOUND" ITEMS

Evaluation of ASD's Re-scoring Standards and Methodology

The ASD's audit procedures for reclassifying or "re-scoring" field audit findings were first disclosed in the April 7, 1999 Public Notice. In the Public Notice, ASD gives a lengthy explanation of its re-scoring standards, stating that:

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[23] Loebbecke Affidavit, ¶ 17.
[24] Loebbecke Affidavit, ¶ 17.

In order to warrant a change in scoring, this additional evidence had to have strong probative value equal to the physical inspection evidence. Carriers were advised to provide adequate and convincing documentation that would make clear that the actual condition was different from what appeared to the auditor at the time of physical inspection. In response, the carriers provided a range of documentation requesting scoring changes.[25]

There are several problems with not only the re-scoring criteria applied by the ASD but the manner by which re-scoring took place. The most notable problem is that the ASD never disclosed to or discussed with the RBOCs their re-scoring standards or the specific documentation needed to meet the above "probative evidence" standard prior to date of submission. It is no wonder that the ASD received a broad range of documentation requesting scoring changes, as the Company and other RBOCs were left to interpret such re-scoring criteria themselves. As authoritative auditing literature does not prescribe specific evidentiary standards for the evaluation of support documentation, the Company was left with no other choice than to judgmentally evaluate the documentation accumulated and assess its reasonableness.

The ASD clearly imposed strict evidentiary standards in its review of support documentation but neglected to perform the most basic, and most persuasive, of audit procedures to verify the accuracy of such documentation and the existence of the assets in question, even though the ASD states (correctly) in the Public Notice that "the best evidence that verified whether an item was accurately recorded in the CPRs was the auditors' physical inspection during the field audits."[26] The obvious question that still begs to be answered here is -- why didn't the ASD auditors ever go back into the field to re-verify their initial physical inspection results and/or validate the supplemental evidence as to the asset's existence provided by the Company?

The auditors never returned to the field to re-verify its scoring by physical inspection or discussed the results of their scoring with the appropriate U S WEST personnel. The existence of additional audit evidence should at a minimum give rise to procedures to validate such information, particularly given the magnitude of the ASD's recommended write-downs. Such procedures cannot properly be performed "in a vacuum" by the ASD but rather must involve interaction with Company personnel where the merits of the additional audit evidence can be discussed and interpreted. This is especially necessary given the different forms of documentation maintained by the individual RBOCs, where different forms of documentation may be used differently from one company to the next in support of plant accounting entries. As noted in my Prior Declaration, in May 1999, AA visited three Colorado central offices included in the ASD's sample to (1) test the reasonableness of ASD's evidentiary standards described above, and (2) attempt to re-verify COE items that ASD scored "not found" or "unverifiable." We were able to find five and partially find two additional sample items out of 18 in total that the ASD had scored "not found." We also noted three additional items that should not have been included in the sample in the first place. The results of

[25] Public Notice, p. 2.
[26] Public Notice, pp. 1-2.

our limited testing indicate that the audit results as re-scored are, at a minimum, suspect.

The ASD's "probative evidence" standard is not a term of art in the auditing profession and prescribes a standard over and above that suggested by GAAS or GAGAS. GAAS recognizes that the nature and extent of audit evidence will vary among audits and that proof "beyond a reasonable doubt" will rarely be obtained. Thus, the ASD's "probative evidence" standard in the real world will rarely, if ever, be achieved. What GAAS (as well as GAGAS) then directs the auditor to do is obtain additional persuasive evidence - not ignore the documentation supplied because it doesn't meet, in the ASD's interpretation, this arbitrarily high standard.

Further, the ASD did not review internal controls over the hardwired COE CPRs in order to determine the nature, timing and extent of audit testing to be performed. In addition, the ASD didn't develop a proper understanding of the COE internal control environment in order to provide the basis for the evaluation of specific audit evidence and audit results. A review of internal controls not only could have influenced the nature and scope of audit testing procedures performed by the ASD in its audit, but it would have provided the ASD a sound basis for accepting or rejecting various types of supporting documentation supplied by the companies. For example, had the ASD reviewed the controls over U S WEST's retirements process, including key systems used in the retirement of COE assets, and found them reliable, then reliance on computer generated documentation of COE retirements as valid supporting documentation would clearly have been justified. By failing to review internal controls over COE-related processes, the ASD failed to justify any standard for review of support documentation.

As discussed above, many deficiencies were noted with respect to ASD's compliance with GAGAS, which standards were supposedly followed by ASD in performing its audits and evaluating additional support documentation. Standards of review must exist so that all persons conducting the audit and interpreting its results understand the criteria to determine if an item is "found" or is "not found" and the financial implications of such a finding. These standards, or guidelines, should be clearly documented and communicated so that all parties have a common understanding of what will constitute a compliant item. If the ASD's scoring and re-scoring criteria were known in advance, as is the normal procedure in conducting an audit, the Company could have gathered additional audit evidence in accordance with such requirements. Additionally, the Company could have provided documentation and/or explanations along with the evidence submitted in order to prove that such evidence was "probative" in nature. At a minimum, knowledge of the ASD's re-scoring standards would have facilitated a more efficient, if not more accurate, process of both gathering additional documentation to evidence the existence of sampled COE items (by the Company) and reviewing and evaluating the reliability and validity of such documentation (by the ASD).

As a result, ASD's re-scoring standards and methodology were deficient with respect to the timing of their communications to the auditee, the restrictive and arbitrary use of the "probative evidence" standard, the disregard of pertinent authoritative standards for the determination of sufficient and competent evidential matter, and the failure of ASD to review internal controls in order to determine what evidence could be relied on. Such deficiencies render the re-scoring process and the audit results determined therefrom unreliable.

PROPRIETY OF ATTRIBUTING AUDIT RESULTS TO PRIOR PERIODS

The ASD performed a physical verification of hardwired COE assets in order to verify the existence of such assets as of the audit date (June 30, 1997 in the case of U S WEST). "Assertions about existence or occurrence address whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period."[27] In other words, procedures performed to test the existence of assets are relevant only to the point of time (given date) at which such procedures are performed.

Certain audit tests can be performed at dates other than the financial statement date in accordance with GAAS. When performing such tests, however, additional testing must be performed in order to provide the auditor adequate assurance that the test results remain valid throughout the period of time from the testing date to the financial statement date, as discussed below:

> Substantive tests should be designed to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of the interim date, and any audit assurance provided from the assessed level of control risk, achieve the audit objectives at the balance-sheet date.[28]

The standards go on to state that there are many factors that the auditor must consider in the performance of procedures at an interim date and the application of the results of such procedures to the balance sheet date, including:

- The nature and effectiveness of relevant internal controls,
- Changes in business conditions or circumstances that may render the interim test results unreliable or misrepresentative, and
- Whether the balances of the particular accounts are reasonably predictable with respect to amount, relative significance and composition.

The performance of additional substantive tests to cover the remaining period **must** also be performed in order to "provide a reasonable basis for extending to the balance-sheet

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[27] AICPA, Statements on Auditing Standards, AU Section 326: Evidential Matter, "Nature of Assertions."
[28] AICPA, Statements on Auditing Standards, AU Section 313: Substantive Tests Prior to the Balance-Sheet Date, "Extending Audit Conclusions to the Balance-Sheet Date."

date the audit conclusions relative to the assertions tested directly or indirectly at the interim date."[29]

While the above guidance is relevant specifically to the extension of audit conclusions from an interim date to the balance sheet date, the same logic applies in the extension of audit conclusions to a prior date. In this case, the issue is whether any of the ASD's audit conclusions as of June 30, 1997 (audit date) can be applied back to the initialization of interstate price cap rates (January 1, 1991). An analysis of authoritative auditing standards indicates that such an attribution cannot be made:

- The ASD did not review internal controls over the hardwired COE accounts throughout the period from 1991 to 1997. Thus, no assumptions can be made with respect to the controls designed and in place throughout that period. Clearly one cannot assume that asset overstatements, to the extent that they exist, were equal to, higher or lower than June 30, 1997 levels.

- Obviously the telecommunications industry has undergone significant change throughout the 1990's. The impacts of economic, industry, business process, systems and personnel changes render any application of 1997 test results back to 1991 meaningless.

- The nature and amount of hardwired COE assets has changed significantly over time, from electromechanical to analog to digital switching technology, for example.

- Finally, and most importantly, no substantive tests were performed during the period from 1997 back to 1991 that provide the ASD any basis for applying the audit results back to prior periods.

As the ASD did not perform any audit tests covering the period from June 30, 1997 back to January 1, 1991, there is no basis to attribute its June 30, 1997 audit conclusions back to that date. Similarly, there is no basis to suggest that a rate reduction is required due to the Company's initial price cap rates being inflated.

IMPROPRIETY OF "PHANTOM PLANT" CONTENTIONS

AT&T and MCI WorldCom suggest in their comments that many of the Company's hardwired COE assets, including both assets "not found" and undetailed investment, were never placed in service. This contention was never raised in the ASD's Audit Report for good reason - the ASD audit was neither designed nor performed with the intent to draw such conclusions. As noted above, the type of audit performed by the ASD does not support an opinion of any kind with respect to the fairness of COE plant account balances. Only the specific procedures performed and the findings related to those specific procedures can be reported on. There were no procedures performed with

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[29] Id.

respect to determining the root cause of any of the ASD's findings - thus, no conclusions can be drawn with respect to such potential causes.

The only way to assess whether there are hardwired COE assets that have been recorded on the Company's books but never placed in service is to perform tests of the Company's internal controls, methods and procedures with respect to the hardwired COE procurement process. Such tests can include both compliance tests of the effectiveness of internal controls over COE plant additions as well as substantive tests to ensure that all, and only, actual plant additions were recorded on the books. The ASD's audit did not include such tests.

An even more troubling implication of these "phantom plant" contentions is that the Company has intentionally misstated its financial records by recording assets in the financial statements that never existed - in other words, significant fraudulent financial reporting has occurred. Clearly this is not the case. GAAS require the independent auditor, on an annual basis, "to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."[30] AA has performed the audits of U S WEST's consolidated financial statements beginning in 1996. Prior to 1996, the annual audits were performed by another "Big 5" public accounting firm. Our audit work from 1996 to the present date, as well as our communications with the predecessor auditors and review of their audit workpapers, has uncovered no instances of material misstatement of the financial statements due to fraud.

UNDETAILED INVESTMENT

The ASD has recommended that U S WEST write-off the balance in the undetailed investment account as of June 30, 1997. The Company should not record this write-off. The undetailed investment category is used as a repository to store capitalizable costs until they can be recorded in the proper categories within the detailed continuing property record ("DCPR") system. Amounts included in the undetailed category are recorded in the proper general ledger plant account, in the proper vintage year and wire center, but are awaiting the necessary detail to assign the appropriate equipment CPR number. Just because there is a balance in this CPR category at an interim date within 1997 does not mean that the dollars recorded therein are erroneously recorded.

Each year, U S WEST performs an activity called the "annuals process." This process is performed in order to properly categorize the dollars recorded in the undetailed investment category in the CPRs. The dollars were originally recorded in undetailed investment because certain data elements were not present at the time the COE was originally recorded; therefore, the equipment could not be recorded in the DCPR in the final category. This process is perfectly reasonable for U S WEST to follow,

[30] AICPA, Statements on Auditing Standards, AU Section 316: Consideration of Fraud in a Financial Statement Audit, "Introduction."

as it is consistent with the FCC's prescribed use of clearing accounts in Part 32 of its Rules and Regulations. These clearing accounts are used in order to hold dollars until their final accounting can be properly determined. The use of clearing accounts is common practice by virtually every company in every industry. The undetailed investment category is in essence the "clearing account" maintained within the CPRs.

In addition, U S WEST has informed us that certain nonregulated plant is tracked in the undetailed investment category for administrative ease. These dollars, which totaled approximately $106 million, were inadvertently included in the amount disclosed to the ASD as of June 30, 1997. These amounts should not have been included in the ASD's recommended write-off. U S WEST provided evidence to the ASD prior to the release of its Audit Report that nonregulated plant was improperly included in the undetailed investment amount disclosed to the ASD, but the ASD failed to recognize this evidence and reduce its recommended write-off accordingly. The fact that the Company chooses to track nonregulated plant in the undetailed investment category is strictly a business decision and in no way should be deemed as erroneous accounting.

As of June 30, 1997, U S WEST had approximately $218.6 million in the undetailed investment category. Based on information provided to AA by U S WEST, as of December 1998, U S WEST had cleared all but $1.7 million of the original June 30, 1997 undetailed investment (not including the nonregulated plant discussed above) to the proper DCPR categories. By August 31, 1999, the balance in undetailed investment was approximately $23 million (including certain nonregulated plant investment), thereby demonstrating the fluctuating nature of this category. Thus, at the current time, there are no significant regulated COE investment dollars from June 30, 1997 in the undetailed investment category to write-off and the ASD's recommendation should be rejected.

CONCLUSION

In summary, the ASD's limited physical verification audit procedures were not sufficient to form an opinion, in accordance with GAAS, as to the fair presentation of the Company's hardwired COE plant investment. ASD's reliance on GAGAS was both misstated and narrowly selective and is insufficient to compensate for those provisions of GAAS not used in the audit plan or execution. Specifically, ASD's failure to conduct corroborating testing of internal controls and ledger account balances and their failure to completely and consistently evaluate the significant evidential matter submitted by the Company and external sources, including Arthur Andersen, together with previously identified audit deficiencies, render the audit findings, conclusions and recommendations unreliable. Additional quality control procedures over the physical verification tests that were performed as well as additional compliance and/or substantive audit procedures would be necessary to render an opinion on the fair presentation of U S WEST's COE account balances pursuant to GAAS.

This concludes my declaration.

Pursuant to 47 C.F.R. Section 1.16, I declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed this 25th day of October 1999.

Carl R. Geppert

ATTACHMENT 3

Remaining Life Calculation
Direct Weighting
(Dollars in Millions)

Vintage	Age	Remaining Life	Original Distribution		Even Retirement Distribution		Dick Lee's Retirements Old Vintages Retired		Audit Findings Distribution (60% 1997-1993)		
			Investment	Weight	Investment	Weight	Investment	Weight	Investment	Weight	Percent
	a	b	c	d=b*c	e	f=b*e	g	h=b*g	I=b-(100*K)	j=b*I	k
1997	0.5	9.5	40	380	32	304	40	380	28	266	12.0%
1996	1.5	8.5	40	340	32	272	40	340	28	238	12.0%
1995	2.5	7.5	40	300	32	240	40	300	28	210	12.0%
1994	3.5	6.5	40	260	32	208	40	260	28	182	12.0%
1993	4.5	5.5	40	220	32	176	40	220	28	154	12.0%
1992	5.5	4.5	40	180	32	144	40	180	35	157.5	5.0%
1991	6.5	3.5	40	140	32	112	40	140	35	122.5	5.0%
1990	7.5	2.5	40	100	32	80	40	100	35	87.5	5.0%
1989	8.5	1.5	40	60	32	48	40	60	35	52.5	5.0%
1988	9.5	0.5	40	20	32	16	40	20	35	17.5	5.0%
1987	10.5	0.5	40	20	32	16	0	0	35	17.5	5.0%
1986	11.5	0.5	40	20	32	16	0	0	35	17.5	5.0%
1985	12.5	0.5	20	10	16	8	0	0	15	7.5	5.0%
Totals			500	2,050	400	1,640	400	2,000	400	1,530	100.0%
Average Remaining Life (Weight/Investment)				4.1		4.1		5.0		3.8	
		Reserve		300		200		200		200	
		Reserve%		60%		50%		50%		50%	
		Remaining Life Rate		9.8%		12.2%		10.0%		13.2%	
		Depreciation Expense		49		49		40		53	

Note: 10 Year Projection Life, Square Curve

ATTACHMENT 4

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October 25, 1999

Mr. Mark Link
Executive Director – Corporate Accounting
US WEST Communications, Inc.
1801 California Street
Denver, CO 80202

Dear Mr. Link:

Deloitte & Touche LLP was asked by US West, Inc. to read and provide comments on the sampling methodology described in the draft FCC report, "Audit of Continuing Property Records of US West as of June 30, 1997; Report of Audit Findings" (the "August FCC Report") and the December 22, 1998 draft of the "Audit of Continuing Property Records of US West as of June 30, 1997; Report of Audit Findings" (the "December FCC Report"). We provided US West with a letter dated August, 18, 1998 containing our comments on the "August FCC Report" and a letter dated January 8, 1999 containing our comments on the "December FCC Report". A copy of those letters is attached hereto.

You have now asked us to read several other documents and provide comments on whether the concerns raised in our letters of August 18, 1998 and of January 8, 1999 (which included several concerns that could affect the validity of the estimates) have been adequately addressed. The documents you have provided to us for this purpose are as follows:

- Affidavit of Robert M. Bell, PhD, filed September 23, 1999
- Affidavit of James K. Loebbecke, CPA, filed September 23, 1999
- Comments of AT&T Corp, filed September 23, 1999
- MCI Worldcom Comments, filed September 23, 1999
- Letter of William Kennard to Congressmen Tanzin and Dingell dated February 24, 1999

Due to the detailed nature of my observations, I have provided them more completely in Attachment 1.

These documents mention certain aspects of the sample design that were questioned in our previous letters, but they do not adequately respond to our concerns. The precise criteria used for excluding some offices and the process used for replacing some sample items remain undocumented. Similarly, discussions of the sample stratification do not adequately address whether the overall number of selections, number of strata, and the number of selections in each stratum were appropriate. Mr. Bell and Mr. Kennard both discuss the issue of the sample design and its representation of high dollar items, but their comments serve to underline our concern that the sample design may have contributed to a large precision. Moreover, they present no information that discredits our observation that dollar-based sampling could be more appropriate than random selection based on units. Typically, when sampling from accounting populations, consideration is given to using dollar-based selection techniques, rather than simple random selections, to allow appropriate coverage of higher dollar items.

Significant concerns with the sample evaluation also remain. For example, all five documents fail to mention the large precision associated with the reported estimates. This is particularly surprising, given that many other issues were discussed that affect the precision (e.g., confidence level, degrees of freedom). One of the most significant criticisms of the statistical analysis appears to have been completely ignored. We therefore reiterate the criticism: *The size of the precision range, which is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.*

The size of the precision range is significant because, based on the statistical literature, no one point in the confidence interval is statistically preferable to any other point. Moreover, sampling theory does not support the assertion that the actual cost of missing plant lies closer to the mid-point of the range (see Attachment 1 for relevant citations from Wonnacott and Loebbecke).

In summary, because the new documents do not adequately respond to the observations made in our letters of August 18, 1998 and January 8, 1999, we continue to have concerns that the approach taken by the ASD may result in invalid sampling estimates. And, we reiterate that, even if the estimate is in fact valid, the size of the precision range, because it is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.

Yours truly,

Ann Thornton

Ann Thornton, Director
National Director – Data Quality and Integrity Services

Deloitte & Touche

ATTACHMENT 1

General Observations on the Reports

Loebbecke affidavit

Mr. Loebbecke's affidavit is notable on three accounts:

1) Statements Mr. Loebbecke makes in his report may not necessarily be applicable to US West. In fact, Loebbecke states (p. 1): "The purpose of this affidavit is to describe my assessment of the statistical sampling methodology and audit procedures used by the audit staff in its analysis of the continuing property records ("CPRs") of Bell Atlantic."

2) Mr. Loebbecke has little comment on the sampling beyond his statement that he read Mr. Bell's affidavit and agrees that the sample design was valid. Mr. Loebbecke does not comment on the estimates or the size of the sampling precision. Mr. Loebbecke's silence on matters of sample evaluation is surprising, considering that he is an authority on statistical sampling for accounting and auditing estimates. (Mr. Bell, in contrast, has no such credentials.) For example, Mr. Loebbecke was chair of the Statistical Sampling Subcommittee of the AICPA and authored the book *Applications of Statistical Sampling to Auditing*.

3) Mr. Loebbecke only makes a very general statement supporting the sample design: "I have read the Affidavit submitted by Dr. Robert Bell concerning the sampling methodology and fully agree with his assessment that the sample design was valid and reasonable given the objectives of the audit and the large number of central offices and equipment items. The staff used a multi-stage sampling design, which is precisely the type of design I would have employed..." (p. 3). It is not clear that he did enough detailed work to support his statement that he supports the sample design, nor does he make any statements about the thorny issues of how the population was defined, how the sample selection was performed, whether bias was introduced, whether the stratification and sample sizes of each stratum were appropriate, etc.

Bell affidavit

Mr. Bell appears to subscribe to a double standard, first stating that his review is not a detailed quantitative review, then criticizing the RBOC's for considering only theory:

- "My review considers only the statistical aspects of the design, data analysis, and inference… I cannot calculate precise quantitative impacts of alternative procedures" (Bell, p. 2).
- "Most of the criticisms of the RBOCs are only theoretical – merely suggesting that certain biases could conceivably exist" (Bell, p. 15).

Despite his criticisms of the RBOCs, Mr. Bell himself makes numerous theoretical, statistical arguments that are supported only by his subjective judgments as to the actual quantitative analysis. For example, Mr. Bell states: "The correction for asymmetry might well exceed the correction for the two-stage design, in which case both limits should be higher than those reported by the FCC staff" (Bell, p. 13). Here he implies that two modifications to the original calculation would result in a higher estimate, but he offers no support for this implication. In the same way, he contends: "These audits used a scientifically valid two-stage stratified sample design" (Bell, p.2). He gives little factual support for this statement, but he does state: "There is no reason to expect that the results of any reasonable alternative design would differ substantially in any particular direction" (Bell, p.2). Once again, Mr. Bell offers only subjective, judgmental support for his theoretical statement.

Mr. Bell also contends that it is useful to derive aggregate point estimates, standard errors, and 95% confidence levels for the seven RBOC's audited by the FCC (Bell, p.14). He does not state why this is useful. Given that so many statistical questions are unresolved in relation to the results for US West, it does not seem appropriate to combine these results with results of the other RBOC's.

<u>Comments of AT&T Corp.</u>

It is notable that AT&T made a number of its own statistical comments without relying on its experts (for example, see pp. 5, 24-27).

AT&T's statistical comments sometimes relied on citations from statistical texts. See below (Observation 9) for one concern related to AT&T's citations. Another concern relates to AT&T's citation from the *Reference Manual on Statistical Evidence* 376 (1994): "A high confidence interval alone means very little" (AT&T, p. 24). Given that this statement is meaningless, it seems likely that the correct citation would have been: "A high confidence <u>level</u> alone means very little." If this mistake was not caused by haste or carelessness, then it probably indicates a lack of understanding of basic statistical concepts.

AT&T also included some statistical commentary. The following commentary appears to be difficult to support: "And here, the *reducto ad absurdum* [*sic.*] of the RBOC's statistical arguments is their claim that the bottom of the confidence interval is below zero. This is an arithmetic impossibility" (AT&T, p. 5). This is an uneducated statement. Using the formulas provided by the auditors in their report, there is an arithmetic possibility of determining a negative confidence limit. Such a limit might not be practical or even valid, but it is arithmetically possible.

<u>MCI Worldcom Comments</u>

The statistical portions of this report in Part IV (pp. 23-26) mainly appear to draw on source material from Mr. Bell's affidavit. Therefore, I am not making any additional comments on this document.

Summary Responses to Prior D&T Observations

We are continuing the numbering scheme initiated in our January 8, 1999 letter (see attached letter) to facilitate the presentation of our comments on the documents provided to us. More detailed explanations of these summary responses are provided below.

Observation	Brief Description of D&T's Earlier Observation	FCC/AT&T Response[1]	D&T Comment on Responses
1	Criteria used on excluding over 500 offices from population was not explained.	Small offices were excluded.	No consistent criteria have been provided that explain how over 500 offices from the population were excluded (see below). We reiterate our August 1998 concern.
2	The process used to replace certain original sample selections was not documented.	No acknowledgement by FCC (Kennard). AT&T and Mr. Bell suggest that the sample selection was unbiased but provide no additional documentation.	Response inadequate (see below). We reiterate our August 1998 concern.
3	The rationale for using a high number of strata, with relatively few selections per strata was not documented.	General appropriateness of a two-stage sample design was defended, but the D&T observation was not addressed.	Response inadequate (see below). We reiterate our August 1998 concern.

[1] This column refers to the responses made in the five documents listed above.

Observation	Brief Description of D&T's Earlier Observation	FCC/AT&T Response[1]	D&T Comment on Responses
4	The explanation of sample design did not address the choice of the number of offices and the stratification of offices.	Mr. Bell admits problems with the calculation of sample size.	Response inadequate (see below). We reiterate our August 1998 concern.
5	Random selection based on units was used, rather than dollar-based sampling, which is more typically used when evaluating the value of accounting populations, especially populations in which the value of individual items varies widely.	Mr. Bell and Mr. Kennard provide further support for our concerns. (Mr. Bell agrees that the sample design is not optimal for producing dollar estimates, while Mr. Kennard explains that the sample was chosen to be representative of the items in the population, not the dollars in the population.)	Response inadequate (see below). We reiterate our August 1998 concern.
6	The precision range was very large, reducing the predictive value of the estimate of error in the population.	No acknowledgement of observation or any response thereto.	We reiterate our August 1998 concern.
7	There was not any reference to sampling guidelines for precision.	No acknowledgement of observation or any response thereto.	We reiterate our August 1998 concern.
8	Documentation was not provided for why mean-per-unit estimators were used, instead of ratio estimators (mean-per-	Type of estimator discussed by Mr. Bell, but his response is inadequate.	Response inadequate (see below). We reiterate our August

Observation	Brief Description of D&T's Earlier Observation	FCC/AT&T Response[1]	D&T Comment on Responses
	unit estimators usually result in a larger precision range)		1998 concern.
9	Sampling theory does not support the assertion that the actual cost of missing plant lies closer to the mid-point of the range.	Mr. Bell and AT&T inappropriately emphasize the importance of the point estimate, which is contrary to cited statistical literature.	Response inadequate (see below). We reiterate our August 1998 concern.
10	Accounting standards do not support using the high end of a range of error, when all points in the range are equally likely of being the actual error.	FCC Comment removed prior to January 8, 1999 letter.	Response resolved our comment.
11	Understatement errors were not considered as an offset to the findings that the population may be overstated.	Parties assert that a one-way audit is sufficient (see below).	Understatement errors still are not offset against the FCC's estimate of overstatement errors. We reiterate our August 1998 concern.
12	No references, formulas, or descriptions of the precise Bayesian approach used were provided.	Mr. Kennard discussed the Bayesian approach, raising additional concerns without providing additional documentation of the approach used.	Response inadequate (see below). We reiterate our January 1999 concern.

Detailed Responses to Prior D&T Observations

Observation 1: Criteria used on excluding over 500 offices from population was not explained.

The following statement from AT&T does not clarify what happened in the case of US West: "Staff excluded from the samples (for some of the RBOC's) very small offices – those with fewer than 100 CPR line items – and locations that were simply too impractical to visit" (AT&T, p.9). While Bell (p. 6) and AT&T (p. 9) note that some offices were included that had fewer than 100 continuing property records, this is contradicted by Kennard's statement that "Offices with fewer than 100 items listed on the CPR were excluded from the audit" (Kennard, #11).

Mr. Bell goes on to argue that "it appears that when the FCC excluded very small offices from the audit sample, it also excluded those offices from the population for which it estimated the total dollar investment in missing HWCOE (equation 19 in Appendix A of the Audit report for Bell Atlantic-South)" (Bell, p.7). Making a determination of what "appears" to be true based on a formula is not an adequate substitute for appropriate documentation from the auditors on which offices were excluded, how the exclusions were performed, and how the exclusions should be expected to affect the extrapolation.

Observation 2: The process used to replace certain original sample selections was not documented.

Similar to Observation #1, no additional documentation is provided that explain how certain original sample selections (e.g., remote locations that are deemed "impractical to audit") were replaced. Mr. Bell and AT&T do state the following:

- "There is, of course, no obvious reason to suspect that very small or out-of-the-way offices would have relatively more or less missing equipment" (AT&T, p. 10).
- "However, the RBOC's failure to demonstrate that the remoteness of an office correlates with the likelihood that items in its HWCOE CPR are missing suggests that no significant correlation exists" (Bell, p. 8).
- "...I have seen no evidence that the number of substitutions was large" (Bell, p.8).

These comments suggest that US West and other RBOC's have the responsibility of demonstrating that the selection process was unfair or that the number of substitutions was large. Making this kind of judgment on the fairness of the selection process is impractical without documentation of exactly how the selection process took place and which original sample selections were replaced (documentation that has still not been provided). In general, it is the responsibility of the auditor to document the selection process used for sampling. For example, we would expect the FCC's auditors to document their selection process.

Observation 3: The rationale for using a high number of strata, with relatively few selections per strata was not documented.

Mr. Bell (pp.4, 9), Mr. Loebbecke (p.3), and AT&T (p.7) note that two-stage stratified sample designs are appropriate for this type of sampling application, but they do not offer any justification for using a high number of strata (i.e., 11) with relatively few selections per strata (i.e., as few as 2).

Observation 4: The explanation of sample design did not address the choice of the number of offices and the stratification of offices.

As with Observation #3, Mr. Loebbecke and AT&T do not explicitly provide support for the choice of the number of offices and the stratification of offices.

Mr. Bell makes the following criticism, which is consistent with our own criticism: "The resulting sample-size calculation was inaccurate…" (Bell, p.8)

Observation 5: Random selection based on units was used, rather than dollar-based sampling, which is more typically used when evaluating the value of accounting populations, especially populations in which the value of individual items varies widely.

Mr. Bell appears to agree with us when he says the following: "The design was essentially optimal for estimating the proportion [*not the dollars*] of missing RBOC hard-wired office equipment… It is true that the variance for estimates of the total cost of missing RBOC hard-wired central office equipment could have been reduced by using an alternative design that oversampled high-cost items. No sample design could perform optimally for both questions" (Bell, p.5).

In our judgment, Mr. Bell's explanation demonstrates that the sample design was less than optimal for dollar estimates. If US West may be held accountable for a certain dollar amount of missing CPR items, it would be reasonable to set up a sample that would produce "optimal" dollar estimates, not optimal estimates of the proportion of missing items.

Mr. Kennard provides further evidence that there was no focus on selecting more high-dollar items when he states: "This stratification, in particular, was instrumental in selecting a representative sample of high, medium, and low value items from all sizes of central offices" (Kennard, #10). He refers to a graph, which apparently is intended to support his point by demonstrating that the distribution of dollar values in the sample is similar to the distribution of dollar values in the population. If we assume that the graph actually demonstrates this point (which is open to question, as discussed below), then the graph only serves to further emphasize that the auditors did not select a sample that focussed on high dollar items. Our judgment, which is supported by Bell (*ibid.*), is that such a sample cannot be expected to provide a dollar estimate with a low variance and precision.

Therefore, the graph adds additional support to our criticisms of the sample design, even if the information on the graph is interpreted in the way Mr. Kennard suggested it should be interpreted. Based on the following concerns with the graph, though, it is probably not appropriate to use the graph to support <u>any</u> point of view at this time:

- The graph does <u>not</u> demonstrate that the "stratification was instrumental in selecting a representative sample…" (Kennard, p.10). The graph depicts only one possible way of looking at representativeness. It does not demonstrate what exclusions were made in the sampling or how substitutions of sample items were performed.
- The graph is labeled "BOC Total", which seems to indicate that although the samples were taken separately for each of the RBOC's , the results for many companies are presented together. Therefore, the graph does not provide a way to make judgments about the US West sample.
- The source and the location of the detailed information supporting the graph is unclear. If this information has been made available, it may be helpful to US West to review the underlying population and sample information. It would then be possible for US West to arrive at a more detailed understanding of the representativeness of the sample and the composition of the population using all relevant information.

In summary, neither Mr. Bell nor Mr. Kennard present information that discredit our observation that dollar-based sampling could be more appropriate than random selection based on units. In fact, both Mr. Bell and Mr. Kennard provide further support for our concerns. (Mr. Bell agrees that the sample design is not optimal for producing dollar estimates, while Mr. Kennard explains that the sample was chosen to be representative of the items in the population, not the dollars in the population.)

Observation 6: The precision range was very large, reducing the predictive value of the estimate of error in the population.

Remarkably, Mr. Bell, Mr. Loebbecke, and AT&T (pp. 26-28) are all silent on this key point. Mr. Loebbecke, as discussed above, avoids discussing the statistical extrapolation entirely. Mr. Bell and AT&T discuss many aspects of the extrapolation, including a discussion of 95% confidence levels vs. 99% confidence levels (Bell p. 12, AT&T p. 27), degrees of freedom in the confidence interval calculation (Bell p. 11, AT&T p. 27), and symmetric vs. asymmetric confidence intervals (Bell pp. 11-12 , AT&T p. 28). These topics only have relevance in consideration of how the confidence interval should be computed.

The following statement from my August 18, 1998 letter remains unanswered: "In this case, the total range of uncertainty is $394.8 million, which is larger than the estimate of $378.6 million. Typically, I would not expect that an estimate with such a wide precision range would be useful."

Observation 8: Documentation was not provided for why mean-per-unit estimators were used, instead of ratio estimators (mean-per-unit estimators usually result in a larger precision range).

Mr. Bell states that ratio estimators, rather than mean-per-unit estimators, were used: "The FCC analysis used standard ratio estimators to estimate the proportion of missing RBOC hard-wired central office equipment and the cost of missing RBOC hard-wired central office equipment (equation 11.25, Cochran, 1977)" (Bell, p.10). Based on our interpretation of the materials originally provided to us, the estimator was a mean per unit estimator, not a ratio estimator.

Mr. Bell goes on to state that the estimator used "…would have a substantially smaller mean squared error than the unbiased estimator for this design" (Bell, p.10). Despite his claims that the mean squared error is "substantially smaller" than it would have been under one of the alternatives, he still does not discuss the large precision resulting from the auditors' choice of estimators.

Observation 9: Sampling theory does not support the assertion that the actual cost of missing plant lies closer to the mid-point of the range.

In several places, Mr. Bell uses unclear terminology that emphasizes the point estimate without appropriately considering the corresponding confidence interval and precision. For example:

- "The Commission's report provides valid point estimates…" (Bell, p.1)
- "I believe that the audit staff's point estimates are sufficiently statistically reliable to warrant a corresponding reduction in CPR values" (Bell, p.9)

Mr. Bell's uses the terms "valid point estimate" and "statistically reliable … point estimates" in his affidavit without defining them. He would have difficulty defining them, because in the statistical literature point estimates are not said to be "valid" or "statistically reliable" unless they are part of a particular confidence interval.

Mr. Bell continues inappropriately emphasizing the point estimate on p. 13 of his affidavit. He states: "Valid confidence intervals are useful for understanding the degree of uncertainty in point estimates". This is correct, but he does not continue to discuss the intervals. Instead, he declares: "The most relevant statistics for adjusting the RBOCs CPR are the point estimates…" He offers no support for this conclusion. He states: "there is no more justification for choosing the lower end of a confidence interval than for choosing the upper end". This is true. He then states: "The best estimate for the amount of HWCOE that is missing is the point estimate." Again, he offers no support based on sampling theory and the relevant statistical literature.

In fact, there is no best estimate in a confidence interval – all points are equally likely from a statistical perspective. This is supported by Chapter 4 in *Applications of Statistical Sampling to Auditing* by James K. Loebbecke and Alvin Arens. In the section on statistical inference, the following statement is made: "the sample mean has no greater chance of exactly equaling the true but unknown population mean than any other value in the confidence interval."

AT&T has also tried to state that point estimates should be preferred to other points in the confidence interval: "The one number that is the best estimate of the true value, however, is the point estimate" (AT&T, p. 25). AT&T claimed that this statement is supported by Wonnacott & Wonnacott, *Introductory Statistics for Business and Economics* (4th ed. 1990), p. 254, but they did not use quotes to set apart a precise citation. It seems likely that AT&T misinterpreted this statistical text. In a previous edition (3rd edition, 1984, p. 220), Wonnacott states: "First, we must decide how confident we wish to be that our interval estimate is right – that it does indeed bracket μ [the population mean]." Wonnacott, like Loebbecke, emphasizes that confidence levels are associated with an entire confidence interval, not with the point estimate.

In summary, both Mr. Bell and AT&T inappropriately emphasize the importance of the point estimate, which is contrary to the statistical literature. Presumably, the FCC and AT&T would agree with the authoritativeness of our references, because we have cited works by individuals whom both the FCC and AT&T have also cited: Loebbecke and Wonnacott.

Observation 11: Understatement errors were not considered as an offset to the findings that the population may be overstated.

Mr. Loebbecke defends the "one-way audit", stating that it "was designed only to estimate the amount of equipment on the books that is missing, not the equipment present but not on the books" (Loebbecke, p. 11). Similarly, he notes that "Completeness was not an objective, as no tests of completeness were included in the audit plan" (Loebbecke, p. 8). While these statements are correct, they do not directly address the question of why it was appropriate to perform a "one-way audit" that did not consider completeness and would not allow understatement errors to offset overstatement errors.

Other statements made by AT&T (p. 11) and Mr. Loebbecke (p. 11) provide additional arguments for the appropriateness of a one-way audit. I have not evaluated these arguments, because they do not pertain to the statistical issues I have been asked to address.

Observation 12: No references, formulas, or descriptions of the precise Bayesian approach used were provided.

Mr. Loebbecke, Mr. Bell, and AT&T do not provide support for the Bayesian approach that was proposed as an alternative to the classical approach. This silence is not surprising, given that there appears to be very little information available on the specifics of the Bayesian approach applied.

Mr. Kennard, however, claims: "From the Bayesian analysis, the auditors have been able to determine that the most probable mean value lies at the midpoint of the range..." (Kennard, #12). It is difficult to evaluate this claim, because Mr. Kennard offers no support or documentation to back up his claim, nor was there sufficient documentation of the Bayesian analysis when it was presented by the auditors (see the January 8, 1999 letter).

While it is hard to criticize an analysis that has not been adequately described or presented, there are several reasons that the Bayesian analysis cannot be seriously considered given the limited information available:

- As already discussed, the Bayesian analysis has not been sufficiently described . It remains unclear how the analysis was conducted, what assumptions were used, how many different variations were tried, etc. As long as the Bayesian analysis remains a "black box", it is impossible to appropriately evaluate it.
- Mr. Kennard contends that the Bayesian analysis was used to determine that the most probable value "lies at the midpoint of the range" (Kennard, #12). It is unclear what range he is referring to. If "the range" refers to "the range known as the confidence interval" (Kennard, #12) derived with classical statistical methods, then his claim contradicts Loebbecke (cited above).
- It is unclear how the Bayesian analysis related to the original audit plan. If the Bayesian analysis was undertaken after the audit to "shore up" a disappointing statistical result, resulting assessments would be inherently suspect and possibly biased.
- Perhaps most serious of all, Mr. Kennard's line of reasoning implies that a Bayesian analysis could be used to provide the "one, best answer" whenever a classical statistical sample produced a result that didn't appear reasonable. Mr. Kennard made his statement that "auditors have been able to determine ... the most probable mean value" (Kennard, #12) even though the precision for the US West extrapolation is greater than half the point estimate (see the January 8, 1999 letter). It is not clear what would prevent him from making this same statement when the precision is two times, three times, or four times the point estimate. It would clearly not be appropriate to use discussions of Bayesian analysis as a way to lend credibility to classical statistical analyses whenever the precision from a classical statistical analysis is large.

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August 18, 1998

Ms. Kristine M. Ringsdorf
Executive Director – Financial Accounting
U S WEST, Inc.
1801 California Street, Suite 2290
Denver, CO 80202.

Dear Ms. Ringsdorf:

Deloitte & Touche LLP was asked by US WEST, Inc. to read and provide comments on the sampling methodology contained in the draft FCC report "Audit of the Continuing Property Records of US West As of June 30, 1997; Report of Audit Findings". I was asked to lead this project, since I am the Firm's designated quantitative techniques expert (statistical sampling, regression analysis, and other mathematical applications) and the National Director of the Data Quality and Integrity service line. As the Firm's expert, I consult on statistical applications for audit and tax purposes as well as for consulting engagements involving regulatory compliance. I have lectured at universities and CPA societies on statistical audit procedures, co-authored books on sampling and auditing, and was a member of the AICPA Subcommittee which drafted the Audit Sampling Guide to support Statement of Auditing Standards, No. 39, *Audit Sampling*.

The focus of a good sampling methodology should be to achieve a valid evaluation. To achieve a valid statistical result from a statistical sampling application, two critical steps must be appropriately performed:

1. In **sample selection**, the objective is to obtain a sample that is representative of the population from which it was selected. A representative selection might be unstratified (e.g., a simple random sample across an entire population) or stratified by some characteristic. Stratification involves dividing a population into subpopulations, based on a characteristic that is identifiable in each population item, selecting a separate sample of items from each subpopulation, and combining the results obtained from each subpopulation mathematically to achieve one combined statistical result.

2. In **sample evaluation**, the objective is to calculate an estimate and a range about that estimate (i.e., precision) at a specified confidence level using formulas supported by a

valid statistical methodology. The evaluation requires a representative sample selection and may only be extrapolated to the population from which the sample was selected.

In general, I do not believe that there is sufficient information in the Draft Audit Reports document to be able to determine whether or not the statistical estimates referred to in the Draft Audit Report are statistically valid. However I can make the following observations, included in which are several concerns, which could affect the validity of the estimates.

Sample Selection

- The definition of the population of the 1,131 offices subjected to sampling is not identified in the Draft Audit Report. The FCC report indicated that U S WEST provided information on over 1,700 offices. Out of this universe of offices, the FCC apparently only used 1131 offices for purposes of stratification and selection. There is no indication what criteria were used to exclude the 500 or more offices. Therefore, I cannot determine whether the population is appropriate for the audit objectives or whether the offices selected are likely to be representative of the population of offices.

  In addition, some initial selections were replaced with alternative selections, but the criteria used in determining what locations were deemed "impractical to audit" are not specified. If it is found necessary to replace randomly selected sample items, for whatever reason, doubts are immediately raised as to the statistical validity of the sampling plan. For this reason, it is customary to rigorously document the replacement process and also document that no bias has been introduced due to the replacement of sample items.

- I cannot assess whether the stratification used was appropriate, in part because of questions around the population definition (as discussed above). I am concerned about the effect of the small number of sample selections from certain strata on the validity of the evaluation. For example, as few as 2 offices were selected within a stratum of offices. Moreover, only 33 offices were selected out of a population of 1,131 offices. Typically, I would expect to see fewer strata with more selections per stratum. There is insufficient documentation in the Draft Audit Report to justify why so many strata with relatively small sample sizes within a strata might be expected to produce representative results.

  The explanation of sample design on pages 3-5 of Appendix A addressed the appropriate size of "n", the number of items reviewed, but it did not address the choice of the number of offices and the stratification of offices. If an insufficient number of offices were reviewed in the multistage sampling approach, the resulting estimates could be biased or invalid. A biased or invalid estimate would not appropriately represent the true but unknown population value.

- Random selection was used to select line items in each selected office. Typically, when sampling from accounting populations, consideration is given to using dollar-based selection techniques, rather than simple random selections, to allow appropriate coverage of higher dollar items. This is particularly relevant in tests of physical existence if high-dollar items are more likely to be located than small-dollar items, due to such factors as physical size and the extent of controls over more valuable assets.

Sample Evaluation

- Statistical point estimates are only meaningful when they are combined with statements of confidence level and precision. In my judgment, the precision of $197.4 million is very large in comparison to the estimate of $378.6 million (52% of the estimate). The precision of $197.4 million implies that the total dollar amount of error lies within the range $181.2 million to $576.0 million with a 95% level of confidence. I emphasize that the estimate of $378.6 million is no more likely than any other point in the precision range from a statistical perspective. (This contradicts one of the assertions in footnote 39 on page 12 of the FCC report – see below.)

  In this case, the total range of uncertainty is $394.8 million (i.e., 2 x $197.4 million), which is larger than the estimate of $378.6 million. Typically, I would not expect that an estimate with such a wide precision range would be useful. I would expect that it would be necessary to do additional work, either to improve the precision or to support the use of a particular point within the range. In most instances, an estimate with such large precision would be of little predictive value without the support of independent corroborative information to assist in determining whether any point in the estimated range is reasonable.

  Some U.S. government agencies have developed sampling guidelines for precision and confidence levels. Sampling guidelines help ensure that statistical methods are applied consistently and with reasonable parameters. For example, one Internal Revenue Service regulation indicates that the precision of an estimate should not exceed 10% of the estimate at a 95% confidence level. The Draft Audit Report does not reference any specific sampling guidelines for evaluation beyond the use of a 95% confidence level. In particular, there is no guidance as to the maximum size of acceptable precision ranges.

- A sample may be evaluated using different estimators, of which the most common are ratio and mean-per-unit estimators. The primary difference between the two is that a ratio estimator bases its estimate on the relationship between the total sample dollar error amount and the total sample dollar book amount, while a mean-per-unit estimator bases its estimate on the relationship between the total sample dollar error amount and the number of sample items. The FCC Draft Audit Report, in describing the formula for estimating the cost of hard-wired-COE not found, does not explain why mean-per-unit estimators were used, instead of ratio estimators. Mean-per-unit estimators, while not necessarily biased, usually result in less precise estimates (i.e., estimates with a larger precision range) than ratio estimators.

- I take exception to the conclusions in footnote 39 on page 12 of the Draft Audit Report. First, any amount within a precision range of an individual sampling estimate should be considered to be equally likely of being the actual amount of error. Sampling theory does not provide statistical support for the assertion by the FCC that, "It is more probable...that the actual cost of missing plant lies closer to the mid-point of the range." Second, while we acknowledge that conservatism is a general principle of accounting, when more specific accounting guidance exists, the specific guidance should be followed. In this case, Section C59 of the Financial Accounting Standards Board's *Current Text* sets forth the accounting for loss contingencies (loss contingencies are defined as existing when "it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements" [C59.105.a.]). The accounting requirement for loss contingencies, when no amount within a range is a better estimate of the loss than any other amount states "If no amount within the range is a better estimate than any other amount, however, the minimum amount of the range should be accrued."(C59.107).

- The tests described in the Draft Audit Report address potential overstatement of the population. When tests are performed for both overstatement and understatement, understatement errors are often used to partially offset overstatement errors and therefore reduce the size of the resulting overstatement estimate. US WEST has indicated that instances of understatement are present in the sample items reviewed by the FCC but are not included in the statistical evaluation. If this is true, the estimates presented may be higher than they should be, in that they do not allow understatement errors to reduce the estimated overstatement.

In summary, given the several questions and concerns about the sampling approach taken by the FCC, it is possible that the resulting sampling estimates may be invalid (i.e., the range of the estimate does not contain the actual amount of error in the population). Additionally, even if the estimate is in fact valid, the size of the precision range, which is very large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.

Yours truly,

Ann Thornton

Ann Thorton, Partner

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January 8, 1999

Mr. Mark A. Schumacher
Executive Director – Accounting Operations
US WEST, Inc.
1801 California Street
Denver, CO 80202

Dear Mr. Schumacher:

Deloitte & Touche LLP was asked by US West, Inc. to read and provide comments on the sampling methodology described in the draft FCC Accounting Safeguards Division ("ASD") report, "Audit of Continuing Property Records of US West as of June 30, 1997; Report of Audit Findings" (the "June ASD Report"). We provided US West with a letter containing our comments dated August 18, 1998. A copy of that letter is attached hereto.

You have now asked us to read the December 22, 1998 draft of the "Audit of Continuing Property Records of US West as of June 30, 1997; Report of Audit Findings" (the "December ASD Report") and provide comments on the ASD's response to our observations about the ASD's sampling methodology that we made in our August 18, 1998 letter (which included several concerns that could affect the validity of the estimates).

Based on our reading, the December ASD Report does not address the observations in our August 18, 1998 letter which are most relevant to our summary stated in that letter, which is reiterated herein: *In summary, given the several questions and concerns about the sampling approach taken by the ASD, it is possible that the resulting sampling estimates may be invalid (i.e., the range of the estimate does not contain the actual amount of error in the population). Additionally, even if the estimate is in fact valid, the size of the precision range, which is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.*

We have numbered the observations made in our August 18, 1998 letter (see attached letter) to facilitate the presentation of the basis for our conclusion that the December ASD Report does not address our August 18, 1998 observations which are most relevant to the summary presented above, as follows.

No.	D&T Observation on June ASD Report	ASD Response to D&T Observation	D&T Comment on December ASD Report
1	Criteria used to exclude over 500 offices from population was not explained.	No acknowledgement of observation or any response thereto.	We reiterate our August observation.
2	The process used to replace certain original sample selections was not documented.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
3	The rationale for using a high number of strata, with relatively few selections per strata was not documented.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
4	The explanation of sample design did not address the choice of the number of offices and the stratification of offices.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
5	Random selection based on units was used, rather than dollar-based sampling, which is more typically used when evaluating the value of acounting populations, especially populations in which the value of individual items varies widely.	No acknowledgement of observation or any response thereto.	We reiterate our August observation

6	The precision range was very large, reducing the predictive value of the estimate of error in the population.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
7	There was not any reference to sampling guidelines for precision.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
8	Documentation was not provided for why mean-per-unit estimators were used, instead of ratio estimators (mean-per-unit estimators usually result in a larger precision range)	No acknowledgement of observation or any response thereto.	We reiterate our August observation
9	Sampling theory does not support the assertion that the actual cost of missing plant lies closer to the mid-point of the range.	Footnote 39 of the June ASD Report, which contained the assertion, has been removed.	The assertion continues to be made – see footnote 27 and pp. 12-13 of the December ASD Report. We again note that any individual sampling estimate within a precision range should be considered to be equally likely of being the actual amount of error.
10	Accounting standards do not support using the high end of a range, when all points in the range are equally likely of being the actual error.	Comment removed.	Response resolves our observation.

11	Understatement errors were not considered as an offset to the findings that the population may be overstated.	No acknowledgement of observation or any response thereto.	We reiterate our August observation

Additionally, we noted that the December ASD Report, in Appendix B, included additional results, which were said to be based on a Bayesian approach. However, we note that the discussion presented only results. It did not include formulas, calculations or other information that would be necessary for us to comment on the results presented. Given that there is not just one Bayesian approach, but rather a family of Bayesian approaches and analyses that can be executed in different ways, it is impossible to evaluate the Bayesian results presented in the December ASD Report.

Because the December ASD Report is not responsive to the observations made in our August 18, 1998 letter, we continue to have concerns that the sampling approach taken by the ASD may result in invalid sampling estimates. And, we reiterate that, even if the estimate is in fact valid, the size of the precision range, because it is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.

Yours truly,

Ann Thornton

Ann Thornton, Director
National Director – Data Quality and Intergrity Service Line

ATTACHMENT 5

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August 18, 1998

Ms. Kristine M. Ringsdorf
Executive Director – Financial Accounting
U S WEST, Inc.
1801 California Street, Suite 2290
Denver, CO 80202.

Dear Ms. Ringsdorf:

Deloitte & Touche LLP was asked by US WEST, Inc. to read and provide comments on the sampling methodology contained in the draft FCC report "Audit of the Continuing Property Records of US West As of June 30, 1997; Report of Audit Findings". I was asked to lead this project, since I am the Firm's designated quantitative techniques expert (statistical sampling, regression analysis, and other mathematical applications) and the National Director of the Data Quality and Integrity service line. As the Firm's expert, I consult on statistical applications for audit and tax purposes as well as for consulting engagements involving regulatory compliance. I have lectured at universities and CPA societies on statistical audit procedures, co-authored books on sampling and auditing, and was a member of the AICPA Subcommittee which drafted the Audit Sampling Guide to support Statement of Auditing Standards, No. 39, *Audit Sampling*.

The focus of a good sampling methodology should be to achieve a valid evaluation. To achieve a valid statistical result from a statistical sampling application, two critical steps must be appropriately performed:

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2. In **sample evaluation**, the objective is to calculate an estimate and a range about that estimate (i.e., precision) at a specified confidence level using formulas supported by a

valid statistical methodology. The evaluation requires a representative sample selection and may only be extrapolated to the population from which the sample was selected.

In general, I do not believe that there is sufficient information in the Draft Audit Reports document to be able to determine whether or not the statistical estimates referred to in the Draft Audit Report are statistically valid. However I can make the following observations, included in which are several concerns, which could affect the validity of the estimates.

Sample Selection

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  In addition, some initial selections were replaced with alternative selections, but the criteria used in determining what locations were deemed "impractical to audit" are not specified. If it is found necessary to replace randomly selected sample items, for whatever reason, doubts are immediately raised as to the statistical validity of the sampling plan. For this reason, it is customary to rigorously document the replacement process and also document that no bias has been introduced due to the replacement of sample items.

- I cannot assess whether the stratification used was appropriate, in part because of questions around the population definition (as discussed above). I am concerned about the effect of the small number of sample selections from certain strata on the validity of the evaluation. For example, as few as 2 offices were selected within a stratum of offices. Moreover, only 33 offices were selected out of a population of 1,131 offices. Typically, I would expect to see fewer strata with more selections per stratum. There is insufficient documentation in the Draft Audit Report to justify why so many strata with relatively small sample sizes within a strata might be expected to produce representative results.

  The explanation of sample design on pages 3-5 of Appendix A addressed the appropriate size of "n", the number of items reviewed, but it did not address the choice of the number of offices and the stratification of offices. If an insufficient number of offices were reviewed in the multistage sampling approach, the resulting estimates could be biased or invalid. A biased or invalid estimate would not appropriately represent the true but unknown population value.

- Random selection was used to select line items in each selected office. Typically, when sampling from accounting populations, consideration is given to using dollar-based selection techniques, rather than simple random selections, to allow appropriate coverage of higher dollar items. This is particularly relevant in tests of physical existence if high-dollar items are more likely to be located than small-dollar items, due to such factors as physical size and the extent of controls over more valuable assets.

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- Statistical point estimates are only meaningful when they are combined with statements of confidence level and precision. In my judgment, the precision of $197.4 million is very large in comparison to the estimate of $378.6 million (52% of the estimate). The precision of $197.4 million implies that the total dollar amount of error lies within the range $181.2 million to $576.0 million with a 95% level of confidence. I emphasize that the estimate of $378.6 million is no more likely than any other point in the precision range from a statistical perspective. (This contradicts one of the assertions in footnote 39 on page 12 of the FCC report – see below.)

  In this case, the total range of uncertainty is $394.8 million (i.e., 2 x $197.4 million), which is larger than the estimate of $378.6 million. Typically, I would not expect that an estimate with such a wide precision range would be useful. I would expect that it would be necessary to do additional work, either to improve the precision or to support the use of a particular point within the range. In most instances, an estimate with such large precision would be of little predictive value without the support of independent corroborative information to assist in determining whether any point in the estimated range is reasonable.

  Some U.S. government agencies have developed sampling guidelines for precision and confidence levels. Sampling guidelines help ensure that statistical methods are applied consistently and with reasonable parameters. For example, one Internal Revenue Service regulation indicates that the precision of an estimate should not exceed 10% of the estimate at a 95% confidence level. The Draft Audit Report does not reference any specific sampling guidelines for evaluation beyond the use of a 95% confidence level. In particular, there is no guidance as to the maximum size of acceptable precision ranges.

- A sample may be evaluated using different estimators, of which the most common are ratio and mean-per-unit estimators. The primary difference between the two is that a ratio estimator bases its estimate on the relationship between the total sample dollar error amount and the total sample dollar book amount, while a mean-per-unit estimator bases its estimate on the relationship between the total sample dollar error amount and the number of sample items. The FCC Draft Audit Report, in describing the formula for estimating the cost of hard-wired-COE not found, does not explain why mean-per-unit estimators were used, instead of ratio estimators. Mean-per-unit estimators, while not necessarily biased, usually result in less precise estimates (i.e., estimates with a larger precision range) than ratio estimators.

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- The tests described in the Draft Audit Report address potential overstatement of the population. When tests are performed for both overstatement and understatement, understatement errors are often used to partially offset overstatement errors and therefore reduce the size of the resulting overstatement estimate. US WEST has indicated that instances of understatement are present in the sample items reviewed by the FCC but are not included in the statistical evaluation. If this is true, the estimates presented may be higher than they should be, in that they do not allow understatement errors to reduce the estimated overstatement.

In summary, given the several questions and concerns about the sampling approach taken by the FCC, it is possible that the resulting sampling estimates may be invalid (i.e., the range of the estimate does not contain the actual amount of error in the population). Additionally, even if the estimate is in fact valid, the size of the precision range, which is very large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.

Yours truly,

Ann Thornton

Ann Thorton, Partner

ATTACHMENT 6

ACCOUNTING LOCATION: 41026

Account: 47C

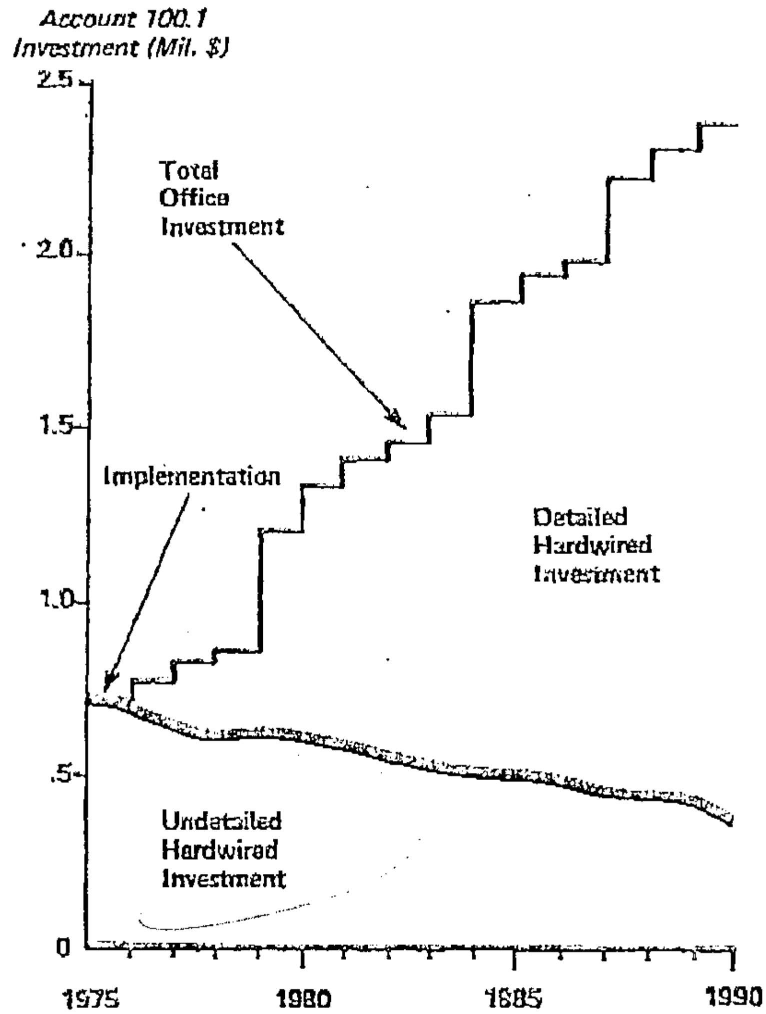

Fig. 4—Typical Office Transition to Detailed Records

hardwired retirement units from the rest of the yearly net additions. These charges are then prorated to each retirement unit added to the office in direct proportion to its material cost.

3. PICS

3.01 An increasing percentage of central office equipment consists of hardwired mounting frames filled with expensive plug-in equipment.

CERTIFICATE OF SERVICE

I, Richard Grozier, do hereby certify that I have caused 1) the foregoing **REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.** to be filed electronically with the FCC by using its Electronic Comment Filing System, 2) a courtesy copy of the **REPLY COMMENTS** to be served, via hand delivery;* and 3) a copy of the **REPLY COMMENTS** to be served via first class United States Mail,† postage prepaid, upon the persons listed on the attached service list

Richard Grozier
Richard Grozier

October 25, 1999

*Served via hand delivery
†Served via U.S. Mail

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Last Update: 10/25/99